ISSUE 46 – JANUARY 2019
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MAGAZINE

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HOW TO INVEST IN 2019

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BREXIT
A GUIDE FOR THE PERPLEXED

MELLON ON THE MARKETS
THE MASTER INVESTOR REVEALS HIS STRATEGY FOR 2019

SHAFTESBURY
GRAB A SLICE OF LONDON'S WEST END

MAGIC FORMULA
HOW TO BUILD A VALUE PORTFOLIO FOR 2019

WELCOME

Dear Reader,

We end 2018 on a decidedly pessimistic note in global markets. Investors are adrift in a sea of risks – there appears to be no end in sight for the US-China trade war, interest rates are rising in most markets, Brexit is in disarray and a no-deal scenario looks like a distinct possibility (to name but a few).

But at times like these we should remind ourselves that sell-offs like the one we're currently experiencing are windows of opportunity for the discerning investor. Our very own Jim Mellon, who believes that the stock-market slide is beginning to reveal value, particularly in the UK, says as much on page 6.

Meanwhile, if Brexit is the thing exercising your mind right now, Victor Hill's "Brexit Guide for the Perplexed" on page 54 should come in handy. Victor reveals the stocks that he believes might be particularly vulnerable after Brexit, along with one sector whose fortunes might begin to look a little brighter.

Whether or not you believe we're on the cusp of a bear market, most people accept that we're pretty late in the market cycle. With this in mind, Filipe R. Costa's "Guide to Building a Value Portfolio" on page 48 could prove useful for those looking to switch out of Growth and Momentum strategies, which traditionally tend to come a cropper towards the end of a cycle.

Nobody knows what 2019 will bring, but the consensus appears to be for a tough year ahead. Whatever the outcome of 2019, we hope that you will continue to find Master Investor Magazine to be a useful source of ideas and inspiration.

On behalf of the whole team at Master Investor, I'd like to wish our readers a very happy and prosperous New Year!

Best regards,

James Faulkner
Editor

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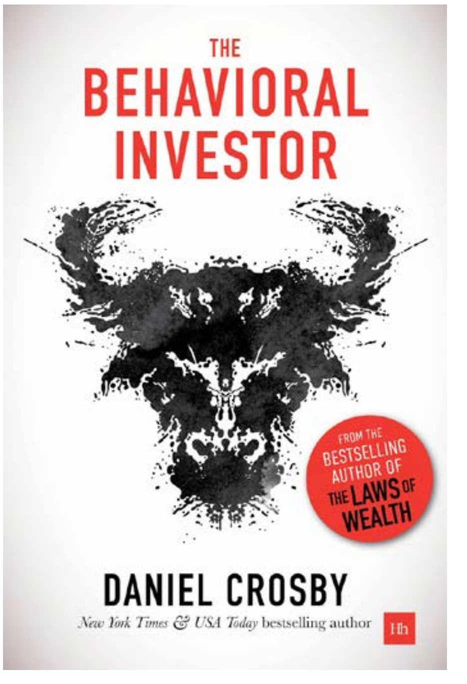

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BY JIM MELLON

MELLON ON THE MARKETS

Readers of a certain vintage will be familiar with the Joni Mitchell lament, "The Circle Game", where the painted ponies go round and round at an ever-faster rate, until the game starts again. In other words, the rider expires. So it is with time. It goes faster and faster as we get older, and in my case, I can't believe how fast this year has gone.

I don't feel I have done nearly enough to justify the 350+ days that have passed – and as a result, I am getting myself one of those big year planners where I am going to clearly set out my objectives for next year.

Amongst them is the completion and publication of an updated version of *Juvenescence*, where not only is the science catching up with the aspiration of ultra-long lives, but the science has now outstripped a fair bit of the first edition.

A second new year resolution is to become thoroughly reacquainted with emerging markets, where the world's fastest growth lies and where values are being laid bare by another dismal year of underperformance. It strikes me that laying down some of the emerging markets might be a good strategy for the next five years or so.

Brexit brings bargains

In addition, all this boring Brexit talk is leading to what will – with another 10 per cent or so – be great buying opportunities in UK Real Estate Investment Trusts (REITs) (see Robert

"JAPANESE BONDS ARE SURELY NOW ONE OF THE GREAT SHORTS IN HISTORY."

Alexandros Michailidis / Shutterstock.com

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Stephens' piece on page 40) and other property vehicles. I have picked up some **Capital & Counties (LON:CAPC)** and **Intu (LON:INTU)** recently as a start, but the really microscopic look will occur in the early period of 2019.

As for Brexit, Mrs May is certainly resilient, in the sense of unwavering. (Whether that is sensible or not, I have no idea.) Personally, I like the Nick Boles idea of a Norway solution and would even go for a second referendum, albeit whether that resolves anything is a moot point. Leave could well win. The pound, only modestly weaker, is signalling a low probability of a crash-out Brexit, and I agree with that.

But British shares, at about 11x earnings, are generally cheap and it might be worth picking some up in anticipation of a Brexit deal, poor thought it may be.

In the event that the UK ends up staying in the EU, might I suggest, in a tongue in cheek way, that we become rule breakers rather than rule takers, and just stay and cause trouble. After all, France has just blown through its budget deficit, and Italy's laughable 2.4 per cent target is about as accurate as a Comintern forecast back in the day.

Slowing growth exposes fault-lines

But there is no doubt that the world economy is slowing; China for sure, Europe to a crawl, and the US showing signs of moderate cracking. This is not surprising given the weight of debt (world debt is up by a factor of 3 in the last twenty years) and the wind-down of easy money. It is worth noting the following: US gross national debt rose by $1.33 trillion over the past 12 months to $21.8 trillion. Critically, China's holdings of Treasuries fell $50 billion to $1.14 trillion while Japan's fell by $76 billion to $1.02 trillion.

Selling of US Treasury bonds is likely to continue as China's current account surplus is down to 0.38% of GDP on its way to nothing, and Japan's trade balance has been moving further into deficit most of this year. This means that support for US treasuries – at a time when the Fed is shrinking its balance sheet, will be diminished. This points to higher yields, especially at a time when the fiscal deficit is ballooning. This is a very difficult time for the Fed to judge what to do; seemingly, the US economy is doing well, but beneath the surface there are cracks the size of the San Andreas fault.

I continue to like gold and silver, because, despite the fact that commodities are down sharply over the past month or so, they have been resilient, and even modestly bullish.

The yield pull-back in the US in the last few weeks probably represents another opportunity to sell US bonds, as inflation seems to be bubbling up there, on close examination of the facts.

Likewise, euro bonds represent extremely poor value, even though negative yields seem to have been consigned largely to history. And Japanese bonds are surely now one of the great shorts in history. And gilts are crazily priced.

at best and overpriced in the case of the US.

In summary, in terms of strategy for 2019, I'm looking at the UK in a modest way, sterling versus the dollar, yen against the dollar, Japan, short bonds everywhere and a smattering of China and general EM. Gold and silver will be brighter next year and are showing signs of a breakout.

There is little likelihood of a strong year overall in 2019, and therefore we need to focus on the pockets of opportunity that undoubtedly are being uncovered by recent market falls. But, remember the old adage that in a bear market – and, surely, we are now in one – the good girls tend to go down with the bad, so be very selective.

Anyway, have a Happy Christmas and a wonderful New Year.

Happy Hunting!

Jim Mellon

"SEEMINGLY, THE US ECONOMY IS DOING WELL, BUT BENEATH THE SURFACE THERE ARE CRACKS THE SIZE OF THE SAN ANDREAS FAULT."

But opportunities remain...

Apart from the UK (where dividend yields are nudging 5%), Japan remains interesting with more or less everything going for it, apart from poor demographics. It has positive earnings momentum, improving corporate governance (pace **Nissan (TYO:7201)**, which looks like a stich up) and a weak currency (a nap for 2019) which enhances export earnings.

In terms of stocks, starting with the conservative picks first, I like **Lloyds (LON:LLOY)** as it is priced almost at distress levels when in fact it is a dividend producing machine; and I like **GSK (LON:GSK)** and **Novartis (SWX:NOVN)**, as well as **Gilead (NASDAQ:GILD)**, in the pharma/biotech space. All three are cheap.

Any major Chinese ETF will do, but more locally I favour **Carrs Group (LON:CARR)** on AIM, and **RestorBio (NASDAQ:TORC)** and **Unity Biotechnology (NASDAQ:UBX)** in the US, both at the forefront of longevity research.

In gold, I remain a director, shareholder and stalwart supporter of **Condor Gold (LON:CNR)**, listed on AIM, and a shareholder in **Venturex (ASX:VXR)** and **Zenith Minerals (ASX:ZNC)** in Australia, both of which I like.

In the US, stay well away from the FAANGs in general – and watch out for individual companies ripe for a fall. A good example closer to home is **ASOS (LON:ASC).** For so long levitated by who knows what, and in one day, as I write, down by 40%.

Dare I say it, this could happen to any one of the FAANGs on a light stumble. In fact, I will wager that it WILL happen!

So, we head into another year of uncertainty – Italy will be the fracture point in Europe, the trade war is not resolved, interest rates are rising in many places and while fiscal policy remains accommodative, monetary policy is not.

That is not a recipe for strong markets, and indeed, most look overstretched

About Jim

Jim is an entrepreneur with a flair for identifying emerging global trends enabling him to build a worldwide business empire. He is amongst the top 10% in the "Sunday Times Rich List" (Britain's equivalent to the Forbes list). He is often described as the British Warren Buffett and he predicted the Credit Crunch of 2007-08 in a book entitled *Wake Up! Survive and Prosper in the Coming Economic Turmoil*. Jim followed this with *The Top 10 Investments for the Next 10 Years* (2008) and subsequently *Cracking the Code* (2012), *Fast Forward* (2014) and, most recently, *Juvenescence* (2017). His monthly "Mellon on the Markets" column in Master Investor Magazine has gained him cult status among investors. He holds a master's degree in Politics, Philosophy and Economics from Oxford University. He is on the Board of Trustees of the Buck Institute in California, a trustee of the Biogerontology Institute, and a Fellow of Oriel College, Oxford.

BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

FOLLOW THE FUND MANAGERS FOR A PROFITABLE 2019

As we say goodbye to 2018 and enter a new year it's time for my annual review of how the UK small-cap markets have performed and to provide a few investment ideas for 2019.

Unfortunately, unlike previous years, 2018 was a pretty dire one for small-cap investors. As I write, with a few trading days of the year left to go, the FTSE AIM All Share has shed 18.9% since 1st January. Despite reaching an 11-year high during the year, the sharp sell-off of the index's constituents which began in October is still in full flow. The FTSE Small Cap Index put in a slightly better performance but still saw 13% shed from its value.

Blue-chips outperformed small-caps during the year, but only by putting in a less bad performance. Despite reaching its own all-time high in May, the FTSE 100 had a difficult year, losing 12.2% of its value as investors' concerns over Brexit dominated the agenda. Only 22 blue-chip companies finished the year higher than they started. The UK-centric FTSE 250 index performed even worse, down by 15.3%, and ended its decade long bull run.

"THERE ARE NOW ONLY TEN BILLION-POUND BUSINESSES ON AIM."


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Small cap "blue-chips" drive disappointment

The usually reliable FTSE AIM 100 constituents, the largest AIM companies by market capitalisation, drove the fall of AIM shares during the year given their outsized contribution to the index. As a whole they were down by 19.1%. There are now only ten billion-pound businesses on AIM, down from 16 at the end of last year.

Online fashion business **ASOS (LON:ASC)** was a major disappointer, with a pre-Christmas profits warning seeing the shares down by 66% for the year to date as I write. Now capitalised at just under £2 billion, the company has lost its status as the largest AIM listed business. Other small-cap heavyweights plunging in value included online estate agent **Purplebricks (LON:PURP)**, down by 64%, and carpet seller **Victoria (LON:VCP)**, down 44%. While posh fizzy drinks seller **Fever-tree (LON:FEVR)** only slipped by 4% over the year, it is currently trading at almost half its September peak.

At the other end of the AIM 100 there were of course some good performances. Litigation financing firm **Burford Capital (LON:BUR)** surged by 41% after securing new funding, taking it to a market cap of £3.3 billion and the top of the AIM hierarchy. Elsewhere, music products business **Focusrite (LON:TUNE)** surged by 47% after trading well during the year, with celebrations and gift wrapping company **IG Design Group (LON:IGR)** also up 47% after growing earnings by 20% for the 2018 financial year.

As bad as it seems?

The largest 10 AIM companies currently make up just over 25% of the total market cap of the AIM All Share out of a universe of 807, so the index's performance is highly dependent on these select few stocks. Therefore, an alternative, and perhaps a more accurate way of reflecting small-cap performance, compared to looking at the AIM All Share, is by taking an equal weighted approach – in other words assuming that an equal amount of money was put into each AIM company at the start of 2018.

To complete this analysis, I take all AIM companies (including those not listed in the All Share) which were listed on the market at the beginning of 2018 and remained listed for the whole year (new listings during the year or those which left the market are excluded). There are 924 qualifying companies, to which I give each an equal weight in my theoretical index.

Of these, 243 companies (26.3%) finished the year with a higher share price, 8 (0.9%) were flat and 673 (72.8%) lost value. The average loss per share on an equal weighted basis was 17.8%, so not much better than

> **"WHICHEVER WAY YOU LOOK AT IT 2018 WAS A BAD YEAR FOR SMALL CAPS."**

the AIM All Share's loss. Whichever way you look at it 2018 was a bad year for small caps.

Top Performers

Amongst the malaise there were of course a clutch of small caps which saw their share prices surge during 2018. There were 20 companies which saw their shares double or more over the year, with 48 growing by more than 50%. Notably, unlike previous years, oil & gas and mining companies did not dominate the biggest gainers, with a broad range of sectors being represented amongst the year's big winners.

Internet of Things investment company **Tern (LON:TERN)** was the number one AIM share of the year, rising in value by 663% after the company raised further funds and expanded its investment portfolio. Oil & gas explorer and producer **Regal Petroleum (LON:RPT)** was not far behind in second place, its shares rising by 662% following an increase in revenues and upgrade in reserves at its Ukrainian assets. In third place was vanadium producer **Bushveld Minerals (LON:BMN)** which grew by 447% despite the company receiving a fine for breach of the AIM rules.

At the bottom of the market 55 AIM shares lost 80% or more of their value over the year. The worst performer was **The People's Operator (LON:TPOP)**, the good cause-focussed mobile virtual network business, which was down by 98.8% after it hit financial troubles and its advisor resigned. LED lighting business **PhotonStar LED (LON:PSL)** collapsed by 97.7% after it remained loss making and appointed administrators to its main trading subsidiary. Also falling from grace was **Flowgroup (LON:FLOW)**, down by 97% before it was delisted in December after it sold its energy business and appointed administrators.

Company	% gain in 2018	M. Cap (£m)	Sector
Regal Petroleum	635	167.5	Exploration & Production
Tern	633	39.1	Software
Bushveld Minerals	447	542.7	Mining
SalvaRx Group	324	31.7	Biotechnology
Pebble Beach Systems	213	6.5	Telecoms

Table: 5 biggest AIM risers in 2018. Performance measured from 1st January 2018 to 19th December 2018

Company	% change in 2018	M. Cap (£m)	Sector
People's Operator Holdings	-98.8	0.2	Mobile Telecoms
PhotonStar Led	-97.7	0.2	Household Goods
Flowgroup	-97	0.0	Energy
Vinaland	-95.7	2.2	Equity Investment
Xeros Technology	-95	16.4	Industrial Engineering

Table: 5 biggest AIM losers in 2018. Performance measured from 1st January 2018 to 19th December 2018

Follow the fund managers

Unsurprisingly given the market backdrop, it wasn't a great year for small-cap fund managers in terms of absolute performance, although some did a good job of minimising losses. Looking at Trustnet's universe of 48 UK small-cap funds, only three have made a gain in the year to date. However, all but one have performed better than the AIM All Share.

Fund	2018 gain/loss (%)
Liontrust UK Micro Cap	3.1
Marlborough Nano Cap Growth	1.3
LF Gresham House UK Micro Cap	1.2
Elite Webb Capital Smaller Companies Income & Growth	-0.2
FP Octopus UK Micro Cap Growth	-2.6

Data source: Trustnet. Note: Performance measured from 1st January 2018 to 19th December 2018

So will it pay to take guidance from the professionals this year? Here follows two growth stocks which some of last year's top performing small-cap funds are hoping will perform well in 2019.

MIND GYM

Last year's best performing small-cap fund, the Liontrust UK Micro Cap, has 2.1% of its assets in **Mind Gym (LON:MIND)**, a unique business which joined the markets in June last year. Co-founded in 2000 by the Harry Potter-esq named CEO Octavius Black (at his kitchen table), the company uses behavioural science to develop learning products which help large organisations to improve the productivity and effectiveness of their workforces. Topics covered include performance management, management development, change, ethics, customer service and (hot topic of the moment) diversity.

mindgym

Mind Gym has built up a portfolio of over 300 learning products which have been used by an estimated two million people in c.1,500 companies and 94 countries around the world. These are typically short duration training courses (less than 90 minutes) and are delivered face-to-face, in virtual classrooms or digitally through a worldwide network of c.300 coaches or by a client's own in-house Mind Gym certified coaches. Revenues are primarily made via the delivery of products by the company's coaches, designing products for clients, content licensing and eLearning.

The products aren't all psychobabble, with Mind Gym having a raft of case studies which show that they deliver a return for clients. For example, one US childcare centre saw client conversion rates up by 24% after implementing one of Mind Gym's behavioural programmes.

So far, Mind Gym has built up a strong market presence in the UK along with a rapidly growing US operation and a small presence in Singapore. Clients are quality blue-chip organisations, with the company having to date worked with 62% of the current FTSE 100 members and 59% of the current S&P 500 constituents. Not only is the client base high quality, in the last financial year Mind Gym had a high level of repeat business, with 88% of revenues coming from returning customers.

The June IPO saw £50.8 million raised for selling shareholders at 146p, giving the firm a valuation of £145 million. Although these kinds of IPO (which act as exit events for the founders) are often criticised, the main selling shareholders (including Black and co-founder Sebastian Bailey) retain a 64.6% holding in the business. What's more, the placing saw an influx of institutional investors, with the share sale said to be "significantly oversubscribed".

"THIS IS A FAST-GROWING BUSINESS, WITH REVENUES GROWING AT A COMPOUND ANNUAL GROWTH RATE (CAGR) OF OVER 20%."

Thinking big numbers

This is a fast-growing business, with revenues growing at a compound annual growth rate (CAGR) of over 20% over the four financial years to March 2018. Profits have also been rising quickly, with the pre-tax figures up from £1.85 million in 2016 to £6.16 million in 2018.

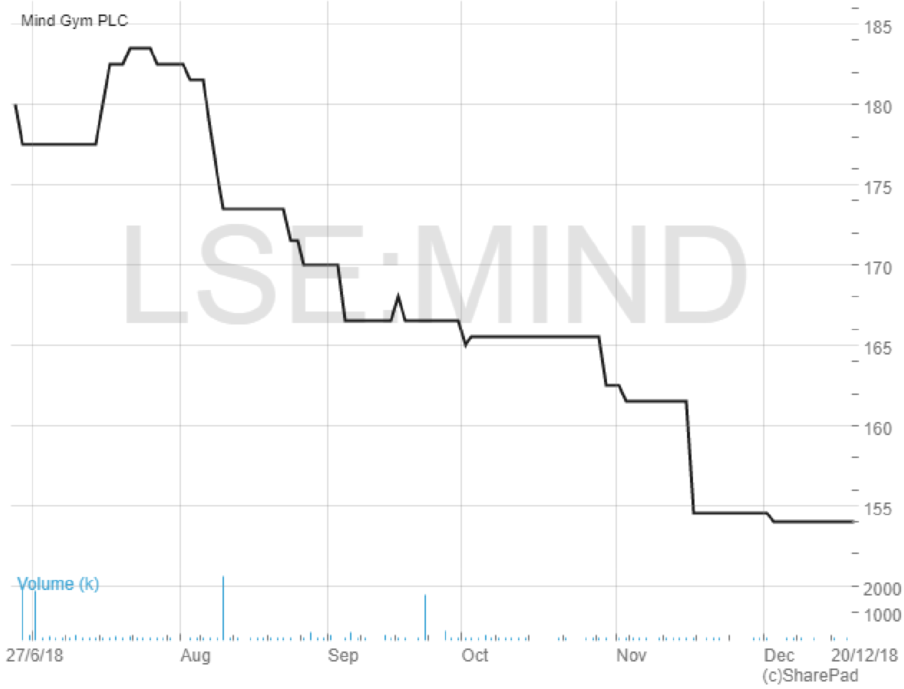
In early December this year Mind Gym released a decent maiden set of results which covered trading in the six months to September 2018. While revenues only grew by 13% to £19.4 million, growth in margins, combined with the operational gearing effect, saw pre-tax profits adjusted for IPO and other one-off costs up by 31% at £4.1 million. Repeat business again drove growth, with 86% of sales coming from clients who have done business with the firm in the past three years. In addition, new clients acquired during the period represent 46% of the total by number. The performance was good enough for the company to announce a maiden interim dividend of 0.8p per share.

Net cash generated from operations in the first half was £2.5 million but this was before the IPO costs of £2.3 million and £3.2 million of pre-IPO dividends. Investors will have to wait until next year (when these one off costs have been eliminated) to get a true idea of cash generation potential. But there are no balance sheet issues, with £2.5 million of net cash at the period end. Should the need arise, the company also has a £2 million unused overdraft facility with HSBC to tap into.

Trading since the end of the period is said to have been positive, with there being a good pipeline of opportunities and the company confident of meeting full-year expectations. Boding well for further margin growth, the percentage of revenue from digital products is expected to grow steadily in the second half and beyond. The company also has high hopes for a recently launched suite of products aimed at preventing bullying and harassment at work.

Mind the valuation gap

Despite a positive open to trading on AIM, shares in Mind Gym have slipped back from a high of 183.5p to the cur-



rent level of 154p – only a few pence higher than the IPO placing price. Trading has been subdued, which is surprising given that the current market cap of £153 million should be attracting attention.

House broker Liberum is currently looking for adjusted pre-tax profits of £8.5 million for 2019 and earnings per share of 6.6p. That puts the shares on a chunky price earnings multiple of 23 times but one which could prove to be worth paying should growth seen over the past few years continue. And there look to be excellent opportunities for further growth.

The talent and workforce consulting market in which the company operates is large – estimated by analysts at ALM Intelligence to be worth $11.5 billion globally and expected to grow at a steady CAGR of 5.2% from 2016 to 2020. Mind Gym believes that its total addressable market for the EMEA region alone is $2.1 billion. So, with a proven product and strong brand name, combined with an increasing focus by companies to improve on issues such as gender diversity and workplace equality, I believe the company looks well placed to expand in this market and beyond.

What's more there are modest income attractions. The dividend policy set out at IPO is to pay out not less than 35% of profits after tax as a distribution to shareholders. Based on Liberum's expectations that would equate to a yield of at least 1.5% at the current share price.

D4T4 SOLUTIONS

Performing well in 2018 for the Marlborough Nano Cap Growth fund was data products provider **D4T4 Solutions (LON:D4T4)**. Previously known as IS Solutions until a name change in 2016, (the 4s are a play on the letter A) the business is now focussed on providing what it calls "solutions for complex data problems", helping companies make the most from their data – from collection through to management and analytics.

D4T4's flagship product is the Celebrus customer data platform, which the company promotes as the most advanced real-time data capture capability in the market, enabling companies to acquire customer data compliantly from websites and mobile applications in real-time as well as from across their entire digital operations. This data can then be used in applications that deliver artificial intelligence, customer insight and analytics, personalisation and customer relationship management. The company focuses on clients

"TRADING IN THE SIX MONTHS TO SEPTEMBER 2018 WAS VERY STRONG."

in industries which gather and use large amounts of data such as retail, financial services and telecoms.

D4T4 currently reports its revenues via four streams. The main business is Products Own IP – a combination of the Celebrus data platform software and software written for use with the company's hybrid cloud data platform business. This comprises automated data management software tools, data migration tools and management support, monitoring and configuration software.

The three other units are: Products 3rd Party – bought in products, hardware and software, to provide environments for the hybrid cloud data platforms; Delivery Services – time and materials services for project inception and deployment and; Support and Maintenance – running, supporting and maintaining the data platform software and hybrid cloud data platforms offerings.

Following a period of investment, trading in the six months to September 2018 was very strong, continuing the momentum seen in the second half of the previous financial year when D4T4 booked in the two largest contracts in its history. Revenues for the period surged from £4.75 million to just under £14 million for the half following significant growth in sales of Celebrus and the hybrid cloud data platform. Sales of third-party products also surged, from £0.45 million to £3.62 million. Combined with gross margins rising from 43.8% to 51%, the adjusted pre-tax profit for the half was £3.35 million compared to a first-half loss of £0.38 million in the previous year.

Without a doubt, the highlight of the period was the superb cash flow performance. D4T4 saw a net £9.4 million inflow from operations in the period, with this mainly being the effect of re-

"FINNCAP HAS A TARGET PRICE OF 240P, WHICH IMPLIES 37% UPSIDE FROM CURRENT LEVELS."

ceivables falling (debts being collected) by £17.9 million, offset by a £12 million fall in payables (creditors being paid). That took net cash at the period end from £3.92 million to £12.06 million, representing 18% of the current market cap. Perhaps conservatively, the interim dividend was increased by 12% to 0.7p per share.

The outlook for the rest of the year was positive, with the company saying that considering contracts forecast to close before the year end, recent new business wins and the depth and quality of prospects, it is confident that the business will achieve a "solid finish" to the financial year.

Worth p4ying 4?

While D4T4 shares have slipped back with the rest of the market over the past few weeks, they remain well ahead of their April lows of 98p. At the current price of 175.5p, the company is capitalised at just under £67 million and trades on a historic earnings multiple of 16 times. House broker Finncap is looking for earnings of 12p per share for the current financial year, meaning the multiple falls to 14.6 times. However, if we strip out the net cash of c.31.6p per share, the multiple falls to a more attractive 12 times – well below the sector average.

With a dividend of 2.8p per share being pencilled in for next year, the current yield is a moderate 1.6%. Providing modest upside to earnings the company recently commenced a share buyback programme. But with the maximum spend allocated at just £100,000 the effect will be minimal. Finncap has a target price of 240p, which implies 37% upside from current levels.

About Richard

Richard Gill is an investment analyst with over a decade's experience of analysing small/mid cap equities. He is the Head of Research at Align Research. Richard qualified with the Chartered Financial Analyst (CFA) designation in 2012 and was awarded PLUS Markets Financial Writer of the Year at the 2008 PLUS Awards. He has been a judge at the Small Cap Awards from 2013 to 2017.

BY DAVID JONES

CHART NAVIGATOR

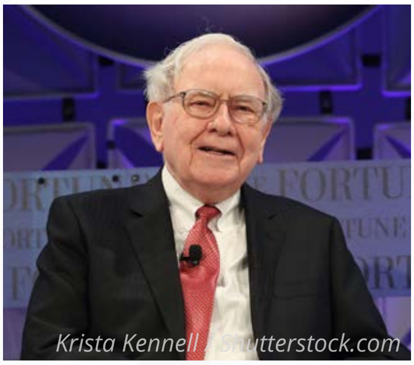
THE LARGEST MOVERS OF 2018 AND WHAT TO WATCH IN THE YEAR AHEAD

It is traditional at this time of the year to take a look back at the winners and losers of the year gone by, and speculate which shares could end up topping the table in the year ahead.

The bigger picture

It has been a difficult year for global stock markets. By the beginning of December 2018, the FTSE All Share was down by more than 10% from the start of the year, and the broader US index, the S&P500, was showing no progress. Stock markets have been in a major uptrend since the end of the financial crisis in 2009, and many of them set fresh all-time highs during 2018. But many factors have shaken investors during the past year.

A significant driver of sentiment has been the strength of the technology sector, which has experienced some wobbles over recent months. Since the summer, there have been worries about the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, Google), and some sharp drops here have spooked markets. Then there are the various political considerations. In recent months, it has been the threat of a trade war between China and the USA, and while, at the time of writing, the trade war has been put on hold for a few months, it is likely to continue to dominate market opinion in the new year.



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"WHEN IT COMES TO HINDSIGHT INVESTING, EVERYONE IS WARREN BUFFET."

Here's what you could have won...

When it comes to hindsight investing, everyone is Warren Buffet. But let's take a brief moment to take a look at the largest gainer in the FTSE 350 last year.

Ocado: (+100%)

"ONLINE GROCERY BUSINESS OCADO (LON:OCDO) WAS THE STAND-OUT TOP PERFORMER AMONGST LARGE AND MEDIUM CAP COMPANIES."

Online grocery business **Ocado (LON:OCDO)** was the stand-out top performer amongst large and medium cap companies, up to December 2018. The share price had doubled for the year – and, actually, by July, it had done even better than that. Despite the fall back since then, it has still been a stellar performance for Ocado. Overseas expansion has been a big factor here, particularly a push into the US market. It was a deal here with Kroger that really boosted the price, lifting it more than 40% in one day. The last few months have seen some uneventful trading for the share price, although, for now, the 700p level does appear to be providing support.

Be glad you avoided this one...

Given that the FTSE 350 losers outnumbered winners by more than two to one during 2018, you should pat yourself on the back if your shares ended the year positive. One of the bigger high-profile losers was travel business **Thomas Cook Group (LON:TCG).**

Remember the scorching summer? Thomas Cook does – and it did the travel business no favours. It led to a fall in demand for last-minute getaways to the sun, with UK holiday makers seeming to prefer Bournemouth to Benidorm. 2018 saw two profit warnings from the business, once again proving the old market adage that the first profit warning is often the sign to get out. The share price fell from 150p in May to as low as 20p in early December. That's a sizeable drop – but as the year ended, the trend from those highs was still down.

Thomas Cook Group (–70%)

> **"EVEN IN VOLATILE MARKETS, THERE ARE STILL SHARES THAT WILL CARRY ON PLODDING UPWARDS."**

What to watch in 2019

And now for the difficult bit – the crystal ball-gazing for what shares could be market out-performers in 2019.

World stock markets go into 2019 on a difficult footing. There is always uncertainty in markets – it just feels like we have more than is usual at the moment. There is still the threat of a trade war - the USA versus the rest of the world, and of course closer to home there is the "will it or won't it happen" tug of war over Brexit. And then there are the usual market concerns over whether the rise in the past ten years has just gone far enough – particularly when it comes to the technology behemoths. Bearing all this in mind, I have used a few traditional charting techniques to highlight what I think are some interesting shares for investors to watch.

The solid trenders

Longer term readers of this column will hopefully know my favourite market cliché by now: *The trend is your friend.*

Markets trend up, down and sideways. To make money, investors need the shares that they purchased to move to a higher price than the price that they bought at. This statement, admittedly, does not tell us anything that we don't already know, but when it comes to picking the right share, there are many different ways to do so. Even in volatile markets, there are still shares that will carry on plodding upwards – and that's what my next two chosen selections are based around.

In choosing my selections, I focused on the FTSE350 and adopted the following simple criteria: shares that have risen both over the last 12 months and six months (in other words, shares that have experienced uptrends in both the medium and longer trends). Only 25 shares made the cut, which illustrates what a difficult market it has been for many investors.

Here's the first selection.

December saw the share price of FTSE250 drinks business **Britvic (LON:BVIC)** do something that many UK shares have failed to achieve for some time: it set fresh all-time highs. Admittedly, this was somewhat short-lived, with investors perhaps using the opportunity to lock-in some gains after a difficult year for the wider market – but it did confirm, from a charting perspective, that the trend was still strong and there was still demand out there from buyers. This latest trend in the Britvic price has now been in place for two years since the December 2016 lows, in the 520p area.

We have a couple of definite reference points to watch if Britvic were to succumb to the wider market weakness. First of all, there is that two-year trendline which comes in around the 730p mark. This trend has done a good job so far in stopping the sell-offs – they ended up being retracements only, before the longer-term trend resumed. In addition to this, the lows in October were set at 740p – once again ahead of that trend line. For now, weakness back towards this 730p/740p zone looks like nothing to be concerned about and would be viewed as just a dip to buy into, under the assumption that the major trend was going to reassert itself.

My second selection is **Hilton Food Group.**

Britvic

Hilton Food Group

With a major trend going back for at least a couple of years now, FTSE250 food producer **Hilton Food Group (LON:HFG)** set fresh all-time highs back in September 2018. The price has drifted since, but not enough to trouble the longer-term trend.

Once again, there are two obvious levels to watch. The trend line is currently sitting around 850p, which is 7% below the current share price. That is the first level to watch if Hilton Food is to come under more pressure. The expectation here would be for strength to resume ahead of the two-year trend line and the share price to recover, initially targeting a move back to those 1,000p highs. Although, even if the trend line were to break, there is still potential solid support at the 2018 low of 760p, so, once again, there is a zone to watch were the share price to slide from current levels. And at the current price, it still looks like a buying opportunity.

The turnaround play

We all love a bargain – and the call of the counter-trend is a strong one. Many investors end up getting their fingers burnt by trying to call the bottom of a falling share – only to see it plunge further. The previous chart of Thomas Cook is a great example of the dangers of buying into a share because "it can't possibly go any lower". But even I would admit that downtrends don't go on forever – so here's one selection that investors may want to follow with the potential of it turning its downtrend around.

Centamin

2018 was not a good year for longer-term holders of mining business **Centamin (LON:CEY)**, with the share price losing around a third of its value. But what is interesting for the casual observer is where this weakness has brought the price in relation to its longer trend. You can see from the chart above that a gradual uptrend that started in 2013 accelerated from 2016 – before later giving up a significant portion of those gains. But that slide has brought the shares back to the longer-term trend once again – and so far it is doing what it is supposed to do and stopping any further slides.

It is early days, but the last three months of 2018 were encouraging, with the shares building a base above the trend line, which is in the 80p/90p zone. And any weakness back to that zone will likely bring buyers back in. It could be an interesting year for the shares after a torrid time in 2018.

About David

David Jones qualified as a technical analyst in 1995 and started his City career as a currency analyst. He then went on to work for trading companies CMC Markets and IG Group as Chief Market Strategist. Since leaving the industry in 2013 he has been a presenter on BBC Radio 5 Live's Wake up to Money programme and the Chartist for Shares magazine. He is an active trader and private investor.

BY NICK SUDBURY

FUNDS IN FOCUS

THE BEST FUNDS FOR 2019

It is never easy to predict with any accuracy what is going to happen in the next year, but 2019 is a lot harder to forecast than most given the serious nature of the issues facing investors. Brexit will probably grab all the early headlines, although there are plenty of other risks to worry about such as the impact of higher interest rates, the slowdown in China and the potential trade war.

The main challenge as we go through 2019 could be the move away from ultra-loose monetary policy and the shift to a rising interest rate environment, monetary tightening and higher inflation.

Ben Willis, Head of Portfolio Management at Chase de Vere, says that with the exception of Japan, and arguably China, central banks are now in quantitative tightening mode.

"How and whether Central Banks can unwind loose monetary policy without making policy errors remains to be seen. This is an area that we need to pay close attention to as it could shape equity and bond returns."

The US Federal Reserve has already telegraphed its interest rate intentions for the year ahead and their policy decisions will have important ramifications for all the different regions and asset classes.

"Rising interest rates should support the US dollar and keep it strong, which is bad news for Emerging Markets," warns Darius McDermott, MD of Chelsea Financial Services. "Couple this with the impact they have yet to feel from the trade war tariffs and the emerging economies could start to slow and see inflation pick up."

> **"INVESTOR CONFIDENCE IS LIKELY TO REMAIN MUTED UNLESS WE SEE CONSIDERABLE POLITICAL PROGRESS AND BETTER STABILITY."**

Brexit

The UK stock market and economy have both been held back by the all-consuming focus on the Brexit process that is still unresolved. Much of the uncertainty has played out on the foreign exchanges, with the pound experiencing periods of sharp volatility.

Mark Dampier, Head of Research at Hargreaves Lansdown, says that Brexit will dominate 2019 with sterling continuing to act as the bellwether for how the negotiations and deals are progressing.

"Investor confidence is likely to remain muted unless we see considerable political progress and better stability, which is unlikely in my view.

"THE US ECONOMY LOOKS SET TO CONTINUE TO BE THE BEST PERFORMER IN DEVELOPED MARKETS; HOWEVER, THAT IS LARGELY REFLECTED IN THE SHARE PRICES AND THE MARKET ISN'T CHEAP."

Should political instability result in a general election in 2019, the markets would react unfavourably to this potential for a change of government."

The risk of a no deal has left many parts of the UK market trading on undemanding valuations, especially those companies that are heavily dependent on the domestic economy.

"One area that we believe will remain sought after is the dividend payers," says Willis. "Even though we are moving into a rising interest rate environment, UK rates remain at historically low levels and any potential hikes from the Bank of England in 2019 are likely to be cursory."

Slowdown in China and the trade wars

The other two main risks – the slowdown in China and the trade wars – are likely to continue to weigh down on global equities, although Dampier thinks that we should fall short of a recession. In spite of all the problems, shares will probably remain the asset class of choice given the low interest rates.

"The US economy looks set to continue to be the best performer in developed markets; however, that is largely reflected in the share prices and the market isn't cheap," says Adrian Lowcock, Head of Personal Investing at Willis Owen. "For further gains we would need to see earnings growth to continue; otherwise, it is hard to justify the valuations."

He prefers Japan where the combination of low valuations and rising earnings per share make it an attractive area to invest, especially given Prime Minister Shinzo Abe's reforms that should result in further improvements in corporate governance.

The Emerging Markets had a tough time in 2018 as a result of the strong

"THE UK IS THE LEAST LOVED MARKET, WHICH MAKES IT A GOOD CONTRARIAN CHOICE FOR INVESTORS."

US dollar, driven by interest rate rises and the US-Chinese trade war. These are significant headwinds that will affect some countries more than others, although a lot of it is already priced in, with data from Research Affiliates suggesting that the shares are 60% cheaper than the US.

The top UK funds for 2019

Dampier says that the UK is the least loved market, which makes it a good contrarian choice for investors. "With a PE ratio of 11.5, it is not cheap, but it's a good price, nevertheless."

His top pick is **Artemis Income,** where manager Adrian Frost has built an impressive track record that has seen him add significant value for investors. Frost's approach has been consistent throughout and a focus on cash-generative companies with the ability to reliably increase dividends has served him well.

Dampier's other selection is **Lindsell Train UK Equity,** which has delivered outstanding performance since it was launched in July 2006 due to Nick Train's excellent stock selection. The manager's relatively conservative investment approach tends to come into its own in falling markets and tough market conditions are where he has tended to add the most value relative to the benchmark.

Many traditional UK equities have sold off to the point where they are yielding well above long term-levels. Ryan Hughes, Head of Active Portfolios at AJ Bell, suggests that income investors who want to benefit from these low prices could try **Troy Trojan Income.**

"Manager Francis Brooke takes a long-term approach with an aversion to

capital losses, which gives a focus on companies that others are shunning. As a result, this UK equity income fund with a strong long-term record is now yielding over 4%. Should Brexit take a turn for the worse, its defensive portfolio might offer some protection from any sharp falls in the UK market."

Value opportunity

Quantitative easing from the world's central banks has created a somewhat artificial cycle with a longer period of rising stock markets but a more muted recovery than history would have suggested. This has enabled growth stocks to outperform value for most of the last decade, but as quantitative tightening gathers pace, value stocks could make a comeback.

"AS QUANTITATIVE TIGHTENING GATHERS PACE, VALUE STOCKS COULD MAKE A COMEBACK."

McDermott's preferred pick in this area is the **Fidelity Special Values (LON:FSV)** investment trust, managed by the well-known contrarian investor Alex Wright. Wright has a value style and normally has a bias towards smaller and medium sized companies, although he is currently favouring the large caps.

Lowcock suggests **Man GLG Undervalued Assets.** Henry Dixon and co-manager Jack Barrat seek to identify two types of stock: those trading below their view of the company's true value and those where the company's profit stream is being undervalued relative to the cost of capital. The resulting portfolio has a value bias, but also includes elements of quality and positive earnings momentum.

Alternatively there is **JOHCM UK Dynamic,** which is recommended by Willis. Manager Alex Savvides is a contrarian investor who looks for opportunities that are either out of favour or being ignored by the broader market. The aim is to find stocks that are down on their luck, but that are going through positive change. He has been managing the fund for a decade and the annualised returns have been excellent.

Other opportunities

A value approach could also work well in other markets outside of the UK, which is why McDermott recommends **Schroder Global Recovery.** The global fund is mainly invested in the developed markets and currently has a large overweight position in Europe. It has a value style and invests predominantly in the large and mega caps.

Lowcock prefers **Schroder Tokyo,** managed by Andrew Rose who has run Japanese funds since the 1980s and is one of the most experienced managers in the sector. He has a forward-looking view and prefers companies that he believes have the potential for positive surprise over two to three years. Rose displays a sensible awareness of social and economic trends and market behaviour, which is a strong complement to his stock-picking skills.

According to Willis, bearish investors might want to consider **Jupiter Strategic Bond,** which is a flexible, go-anywhere bond fund managed by Ariel Bezalel. The flexible remit means that the manager can invest across global fixed interest markets and up-and-down the risk spectrum. This gives him the scope and freedom to identify and unlock value against the more challenging backdrop of a rising interest rate environment.

Another cautious option suggested by Hughes is **Janus Henderson UK Absolute Return,** which has a flexible approach with the managers able to go both long and short (to profit from price falls).

"If equity markets continue their recent volatility, protecting capital may

A more adventurous option

Adventurous investors might want to consider **Polar Capital Global Insurance,** which operates in a specialist part of the market that often goes under the radar, despite the fact that insurance companies have a fantastic ability to generate cash regardless of the economic environment.

"Polar Capital Global Insurance is highly unusual in focusing on this area, but they are experts in this specialist field and this comes through in the quality of management. The strategy has a relatively low correlation with global stock markets and therefore adds useful diversification to an existing portfolio of traditional equities," explains Hughes.

The £1.279 billion fund was launched in October 1998 and has generated an impressive average annualised return of 16.2% over the 20-year period. It typically has 30 to 35 holdings with low stock turnover.

FUND OF THE MONTH

The **Personal Assets Trust (LON:PNL)** has an absolute return mandate, with an objective to "protect and increase (in that order) the value of shareholders' funds over the long-term". Under Sebastian Lyon's management the fund has exhibited considerably lower volatility than the FTSE All-Share and it remains attractively positioned for those who share the manager's current cautious outlook and are looking for a defensive portfolio.

At the end of October the fund had 37.4% invested in equities, 27.4% in US Treasury Inflation-Protected Securities (TIPS), 16.6% in UK T-Bills and 8.4% in gold, with the remaining 10.2% divided between US Treasuries, UK Index-Linked Gilts and cash.

"The significant exposure to government bonds and gold means that it is likely to lag market rises. However, it should also continue to preserve capital in difficult markets and, as such, it remains a low volatility vehicle that we would expect to deliver attractive absolute returns over the long-term," explains Bird.

Fund Facts

Name:	Personal Assets Trust (LON:PNL)
Type:	Investment Company
Sector:	Global Growth
Total Assets:	£906m
Launch Date:	July 1983
Current Yield:	1.4%
Net Gearing:	0%
Ongoing Charges:	0.89%
Website:	www.patplc.co.uk

The shares currently trade at a 1% premium to NAV, but the discount risk is alleviated by the fund's well-established zero discount policy, which has seen shares worth £63 million issued at a premium over the past 12 months. Over the last 10 years, it has made a total share price return of 108%.

be a greater consideration than outright growth. If that is the case, managers Luke Newman and Ben Wallace have proven before that they have the skillset to profit when markets become difficult."

Emerging markets

Emma Bird, Research Analyst at Winterflood Securities, recommends the **JPMorgan Global Emerging Markets Income Trust (LON:JEMI).**

"Emerging Markets have suffered another difficult period, partially as a result of a US rising rate cycle, a slowdown in the Chinese economy and the potential impact of a trade war between the US and China. Perhaps unsurprisingly this has led to discounts widening across the sector and we believe that this presents a value opportunity for contrarian investors."

The fund has been de-rated and at time of writing had moved to a 5% discount to NAV, but it could benefit from a change in sentiment far more than most of its peers, given its strong long-term performance record, the 4.2% yield, and its retail-oriented shareholder base.

"JEMI has performed strongly since launch and while its significant sector and country active positions may lead to periods of underperformance relative to the benchmark, we believe that the manager's emphasis on good quality companies paying attractive dividends will allow it to outperform over the long run," explains Bird.

About Nick

Nick Sudbury is an experienced financial journalist who has written extensively for a range of investment publications aimed at both private and institutional investors. Before moving into journalism he worked both as a fund manager and as a consultant to the industry. He is a fully qualified accountant and has an MBA with finance specialism.

BY JOHN KINGHAM

DIVIDEND HUNTER

MY TIP FOR 2019

USE FREE CASH FLOW TO FIND SAFER DIVIDENDS

With economic conditions heading downwards and the number of dividend cutters heading upwards, a company's ability to generate cold, hard cash is becoming ever more important. And while reported earnings are useful when analysing the sustainability of a company's dividend, I have finally realised there's something better. And that something is free cash flow.

Earnings and free cash flows are not the same thing

The traditional way to measure the safety of a company's dividend is to look at its dividend cover, which is the ratio between reported or adjusted earnings and the dividend. This is what I've always done. However, it's far from perfect because dividends are paid out of cash, and earnings rarely reflect the amount of cash generated by a company.

For example, imagine that you own a small construction company. You sign a contract to build a house and the customer will pay you £1 million when the keys are handed over a year from today. It will cost you £600k to buy the land and build the house and all of your suppliers demand payment up-front. From a somewhat simplistic accounting point of view, you have £1 million in revenues, £600k in expenses and £400k in operating profits, and in theory you could pay out a large chunk of that profit as a dividend.

From a cash point of view, you have zero cash income and £600k of cash expenses. You'll have to raise additional debt or equity just to cover the cash expenses, and the same goes for any dividend which you might (perhaps somewhat unwisely) decide to pay out before the house is completed.

For the most part, especially in large and established public companies, this sort of enormous discrepancy between earnings and cash flows doesn't happen. There is always a

"WITH ECONOMIC CONDITIONS HEADING DOWNWARDS AND THE NUMBER OF DIVIDEND CUTTERS HEADING UPWARDS, A COMPANY'S ABILITY TO GENERATE COLD, HARD CASH IS BECOMING EVER MORE IMPORTANT."

"SOMETIMES EARNINGS AND CASH FLOWS CAN TELL WILDLY DIFFERENT STORIES ABOUT HOW A COMPANY IS PERFORMING."

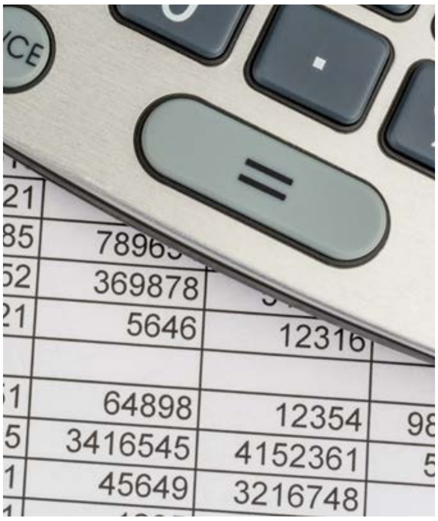
difference, although it's usually quite small, especially when measured over a period of several years. But that isn't always the case, and sometimes earnings and cash flows can tell wildly different stories about how a company is performing.

Depreciation and capex: Two sides of an unbalanced coin

One distortion that crops up quite frequently is the impact of depreciation and capital expenses. Depreciation is a non-cash expense which is supposed to reflect the reduction in value of a company's existing tangible fixed assets (trucks, property, machinery, etc.). Capital expenses are investments in new fixed assets and, despite the name, they're not recorded on the income statement as an expense (they go on the balance sheet as an asset instead). In practice it works something like this:

Imagine you run a widget manufacturing company with one widget machine called Machine O. You bought Machine O ten years ago for £1 million and it depreciates in value every year as it becomes out of date and worn out. This deprecation of value is recorded as an annual expense, even though the deprecation doesn't actually cost you anything each year. As per standard practice, Machine O is depreciated using the straight line method, which means you have an equal £100k non-cash depreciation expense in each of the last ten years. This reduced your reported earnings by £100k each year, even though in cash terms you spent £1 million in cash ten years ago and nothing since.

You can think of depreciation as an estimate of the amount of cash your company needs to put aside each year in order to replace Machine O when it eventually reaches the end of its useful life.



By coincidence, that happens to be this year. So, you decide to buy a new machine called Machine N, and because you've been a sensible CEO you did indeed save an amount of cash equal to Machine O's depreciation each year (£100k per year, remember), giving you a £1 million cash pile to spend.

However, when you go to purchase Machine N you realise that £1 million isn't nearly enough. Thanks to the wonders of inflation, a direct replacement for Machine O would now set you back £1.2 million rather than £1 million. Unfortunately, you don't have the extra £200k because you paid out every penny of your earnings as dividends, and those earnings reflected the historic cost of depreciation rather than the future inflated cost of your next machine.

And it gets worse. Because you're such a good CEO, your business has prospered and in order to maintain that growth, Machine N needs to have twice the production capacity of Machine O. That means it will cost twice as much, but twice £1.2 million, not twice £1 million. So, you find yourself with £1 million of savings because you based your cash allocation decisions (i.e. whether to save cash for a new machine or pay it out as a dividend) on depreciation costs and not the expected cost of future capital investments.

You have a few choices available, which you can mix and match: 1) Borrow the additional funds from your bank; 2) raise funds from shareholders via a rights issue; 3) cut or suspend the dividend (which won't be nearly enough on its own); 4) sell off some of the company's other assets.

None of these options are ideal and perhaps it would have been better if you hadn't paid out all your reported earnings as dividends. The fact is that capital expenses (which aren't deducted from earnings but do affect cash flow) are almost always higher than depreciation expenses (which are deducted from earnings but don't affect cash flow), and that's why reported earnings are routinely higher than the actual amount of 'free' cash a company is generating (free as in doesn't have to be reinvested in the company, paid to the taxman, etc.).

This is one of the problems that free cash flow tries to resolve. Free cash flow starts with net cash from operations, which is basically operating profits with a few tweaks to add back in non-cash expenses like depreciation and take out cash expenses like interest and taxes paid. After that, we remove capital expenses and the end result is free cash flow. This means depreciation is effectively replaced with capex, and we're left with a measure of 'earnings' that gives a much better picture of how much spare cash the company's operations are throwing off.

Tesco: Massive capital expansion led to hidden dividend dangers

Tesco (LON:TSCO) is a good example of the kind of problems this gap between deprecation and capex can cause. Before 2013, Tesco was an obvious example of a successful business. For more than a decade it had grown revenues, earnings and dividends by more than 10% every year. During that time the company had doubled in size and expanded from a primarily UK-based supermarket chain to a global giant. Its dividend had been consistently covered more than twice over by earnings and, from that point of view, there was no reason to think the dividend was unsustainable. As for management, some were considered geniuses and handed knighthoods.

But that only tells half the story, and the other half is far less positive. Looking at the decade to 2012, Tesco recorded a total depreciation expense of £10 billion, which was deducted from earnings. At the same time, it recorded total capital expenses of £31 billion, which was not deducted from earnings. This means that a) Tesco was massively expanding its tangible assets (i.e. supermarkets, warehouses, etc.) as part of the UK supermarket 'space race' and b) its reported profits were boosted by at least £21 billion over the decade compared to the amount of cash generated and available for dividend payments.

From a free cash flow point of view, the company generated £32 billion of cash from operations after interest and tax over those ten years. Take the £31 billion of capital investments away from that and you're left with free cash flows of just £1 billion. Over the same period the company made dividend payments of more than £8 billion, so how did Tesco manage to pay out £8 billion in dividends while generating only £1 billion in free cash?

There are a couple of primary reasons: 1) The company was able to raise several billion by selling off old assets as they were replaced by new assets. 2) Between 2003 and 2012, Tesco's debts increased by almost £7 billion. This more or less covered the growing dividend – but borrowing to pay dividends is unsustainable. At some point the company won't be able to afford the interest payments on its ever-growing mountain of debt.

And that's pretty much what happened. After the financial crisis of 2008/9, Aldi and Lidl started turning the UK supermarket sector upside down. Shoppers cared more about bargain basement prices than stores with creches and luxury coffee bars inside, and Tesco found its operating cash flows falling fast. Capital expenses were slashed in half and the supermarket space race came to an end, but it wasn't nearly enough. With an annual cash dividend of more than £1 billion, Tesco simply wasn't generating anything like enough cash to cover it, so the dividend was cancelled.

How to spot dividends at risk from weak free cash flows

When you look at Tesco's track record through the lens of free cash flows, capital expenses and tangible fixed asset growth, it's possible to see all manner of problems which just don't show up when you're focused on reported earnings. For each problem there's one or more metrics which can help to highlight it, and I'll outline a couple of my favourites here.

Free cash flow dividend cover: This is an obvious one. If free cash flows don't cover the dividend then the company's operations weren't generating enough net cash (net of interest, tax and capital expenses) to pay the divi-

"TESCO IS A GOOD EXAMPLE OF THE KIND OF PROBLEMS THIS GAP BETWEEN DEPRECATION AND CAPEX CAN CAUSE."

Tana888 / Shutterstock.com

dend. However, this isn't necessarily a disaster and most companies have the occasional year when free cash flow dividend cover is below one.

An obvious example is when a company has to build or buy a new manufacturing plant or other expensive fixed asset. For a year or two the free cash available to shareholders will be low because capital investment is high, but this should be a relatively short-lived state of affairs (unlike Tesco, where this was the norm for more than a decade).

When free cash flows are low it's quite easy to cover the dividend by reducing cash on the balance sheet or raising a small amount of debt. That's entirely normal and acceptable, as long as it's just a year or three.

So rather than measure free cash flow dividend cover over a single year, I like to look at it over at least the last decade. Specifically, **I've started counting how many times free cash flow dividend cover was greater than or equal to one over the last ten years.** This gives me a number from zero to ten, with zero meaning the dividend was never covered and ten meaning it was always covered.

Most companies sit somewhere in the middle of that range. In the decade to 2012, Tesco's free cash flows covered its dividend a grand total of once, which is a very large red flag.

Free cash flow growth: As a dividend-focused investor I'm generally looking for companies with a track record of consistent dividend growth. So, in addition to free cash flows which consistently cover the dividend, I also want to see free cash flows increasing over time. I do this because I want to avoid the situation where dividends are going up, but free cash flows are going down, and this can occur even when free cash flows consistently cover the dividend (although if those trends continue, the dividend won't stay covered by free cash flows for long).

Free cash flow growth can be tricky to measure because it can be extremely volatile. A company may have generated £1 billion in free cash flows a decade ago and £0.5 billion last year, but that doesn't tell me much about the long-term trend. Perhaps the company just built a new factory this year, so for a single year free cash flows were depressed, but only temporarily.

To get around this problem **I've started counting how often a company's free cash flows went up over the last decade.** This produces a number from zero (free cash flow went down every year) to nine (free cash flows went up every year).

As with free cash flow dividend cover, most companies sit in the middle, with free cash flows going up and down in about equal measure. Tesco's free cash flows grew four times in the decade to 2012, which isn't terrible, but it is below average.

Of course, there are many more things you can and should look at, but I think looking at how often free cash flows cover the dividend and how often free cash flows have increased, should prove their worth in highlighting unsustainable dividend payers.

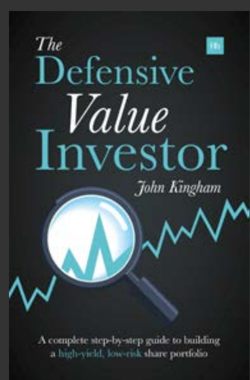
And from a personal perspective, if I'd used those metrics to review Tesco back in 2012, I would never have made the mistake of joining Warren Buffett as a shareholder.

About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

His website can be found at: www.ukvalueinvestor.com.



BY DAVID JONES

FORENSIC FOREX

WHICH CURRENCIES ARE SET TO SHINE IN 2019?

There is seldom a dull moment in the foreign exchange markets. Currencies are a barometer of the health of a country's economy, so if there is an economic crisis, it will usually be reflected in the FX market. 2018 saw its fair share of drama, with the Turkish lira a key focus during the summer as it lost 30% of its value against the US dollar, on concerns of an economic crisis and sanctions from the USA.

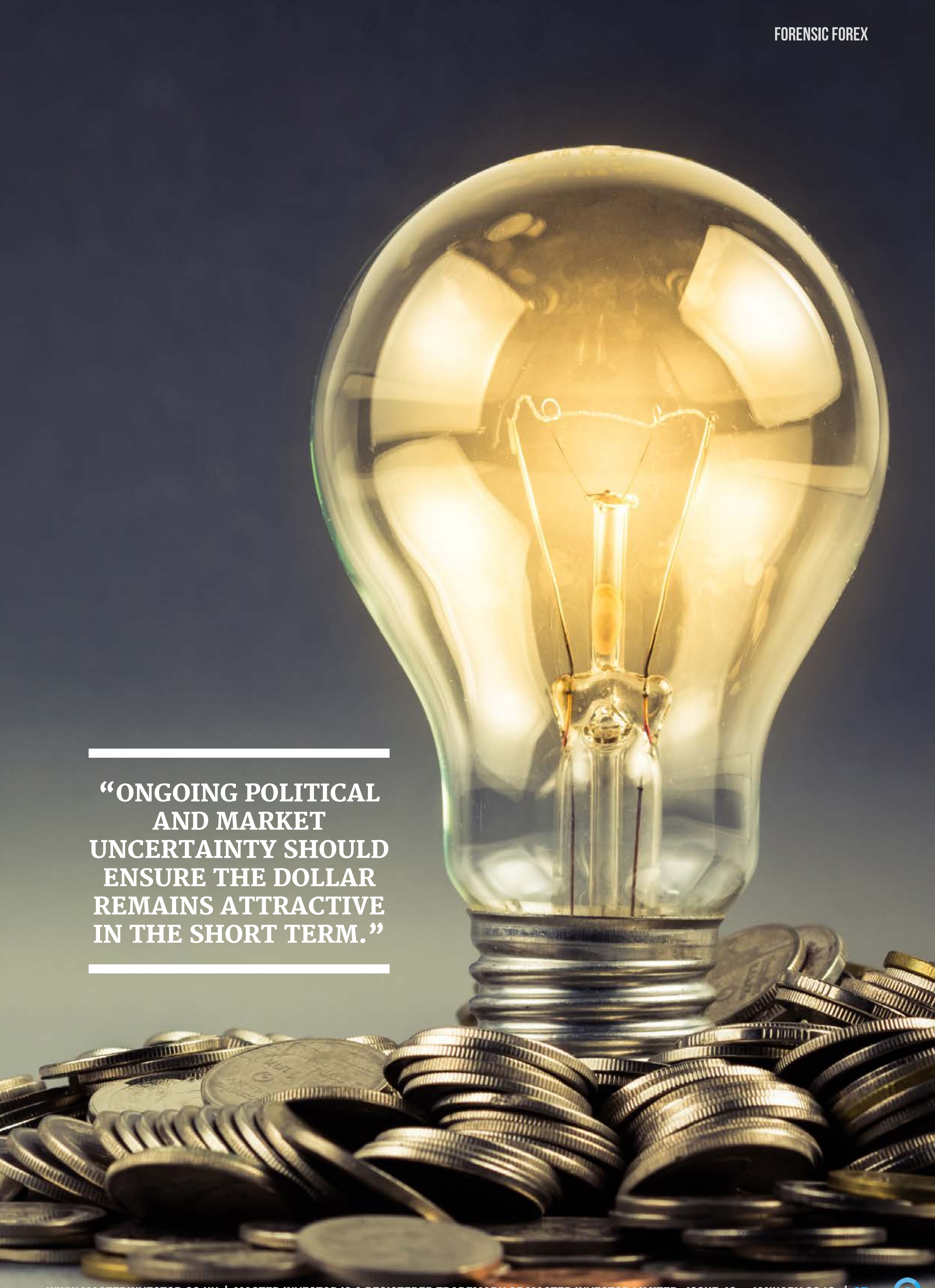
Sticking with the major currency pairs, traders still had plenty with which to occupy themselves. One of the major themes for the year was – yes, you guessed it – Brexit. In April, the pound hit its best level against the US dollar since the EU Referendum, trading at up to 1.43. And then, in December, following a resurgence of the US currency and frustration from the lack of Brexit progress, it hit a 20-month low of 1.25. You don't need a crystal ball to forecast that the pound's volatility looks set to continue into the new year.

As it is the start of 2019, I thought it would be interesting to look at three different markets which may appeal to both investors and traders in the year ahead, depending on their attitude to risk.

One for the conservative: US dollar continues as a safe haven

Although Brexit woes weighed on the pound in the second half of 2018, it was dealt something of a double whammy as the US dollar made an impressive comeback. 2017 had been the worst year for the American currency for 14 years – and many analysts had expected this to continue. That was the case for the first few months, but from April it started to move higher against a basket of currencies, gaining 10% by December.

It has become something of a safe haven in times of trouble – and the second half of 2018 saw plenty of volatility for stock markets, which may have persuaded investors to stash their cash somewhere else, further boosting the dollar. Ongoing political and market uncertainty should ensure the dollar remains attractive in the short term – the only worry here is that it has already performed well for quite some time. Probably the easiest way to track the dollar is watching the most traded foreign exchange pair, the euro/US dollar rate. As can be seen from the chart below, the euro finished 2018 near its lows for the year.



"ONGOING POLITICAL AND MARKET UNCERTAINTY SHOULD ENSURE THE DOLLAR REMAINS ATTRACTIVE IN THE SHORT TERM."

EUR/USD 2018

One for the brave: pound surges as politicians unite to resolve Brexit

Writing this as the pound hits fresh 20-month lows is maybe the very definition of financial markets optimism. Since April 2018, the pound has lost 12% of its value against the dollar, declining from 1.43 to below 1.25. The lack of progress on Brexit, the cancelling of the planned December vote on Theresa May's proposed deal, the Conservative leadership challenge – pick your favourite reason; they have all had an impact.

Given the many contributing factors, it is difficult to see the light at the end of the tunnel for the pound – and this is despite the fact that the UK economy is, on the face of it at least, doing okay.

Maybe, just maybe, the pessimism has gone too far. If you agree with that, then perhaps stability returns to the pound in 2019 and it, once again, starts a recovery. Even if that does start to happen, it is still not a trade for the faint-hearted. Volatility is very much the order of the day for GBP/USD, and with the UK still expected to leave the EU at the end of March, there should be plenty of shocks in the first three months of the year at the very least. But despite the current political shambles, GBP/USD ended 2018 around 5% above the 2017 lows of 1.20, and the brave may think enough gloom has been priced into the UK's currency for now.

One for the rest – speculative, with a sprinkling of safety?

I last wrote about gold in the November issue of Master Investor and it has moved slightly higher since then – but there could well be more to come in 2019. It has not been the best of years for long-term holders of the yellow metal. It peaked around $1,360 in April,

GBP/USD 2016 – 2018

but then slid to $1,160 by August. This was another market that became a victim of the dollar's resurgence – as the US dollar rises, traditionally the price of gold slides.

But the last few months of the year saw some change and the gold market started to recover, and the stock market volatility may have played a part here. Although gold has perhaps lost some of its safe-haven appeal to the US dollar, it is still a destination for investors in times of trouble. After almost ten years of rising stock markets, the wobbles in 2018 may have encouraged some to take some risk off the table to see what happens next – and that will have benefited the price of gold.

Then there is the inflation angle. The cost of living is on the up after a period of near-zero inflation. The threat of trade wars and tariffs continues to hang over the global economy, and that could push up the costs of imported goods of the world's major economies, which would have a knock-on effect on inflation. It's early days in the rising inflation cycle, but it's another factor that could play into the hands of the gold bulls, and see the yellow metal once more regain its popularity with a wider investor base.

2019 has a lot to live up to if it is going to match the volatility and drama of the previous year! Either way, it will be another fascinating 12 months for all sorts of asset classes – and those dramas will be played out on the world's foreign exchange markets.

"ALTHOUGH GOLD HAS PERHAPS LOST SOME OF ITS SAFE-HAVEN APPEAL TO THE US DOLLAR, IT IS STILL A DESTINATION FOR INVESTORS IN TIMES OF TROUBLE."

GOLD US$ 2018

About David

David Jones qualified as a technical analyst in 1995 and started his City career as a currency analyst. He then went on to work for trading companies CMC Markets and IG Group as Chief Market Strategist. Since leaving the industry in 2013 he has been a presenter on BBC Radio 5 Live's Wake up to Money programme and the Chartist for Shares magazine. He is an active trader and private investor.

BY ROBERT STEPHENS, CFA

STOCKS IN FOCUS

WHY LONDON'S WEST END COULD OFFER LONG-TERM INVESTMENT APPEAL

Buying a commercial property stock may not appear to be a sound move at the moment. The UK economy faces a highly uncertain near-term future from a political and economic perspective, with Brexit likely to dominate the news agenda beyond the end of 2018. This could cause investors to demand an increasingly large margin of safety for companies operating within the property sector as a result of its cyclicality and reliance on the wider UK economy.

However, real estate investment trust (REIT) **Shaftesbury (LON:SHB)** could offer long-term investment potential. The company's stock price has declined by 15% in the last year, which means that it now trades at less than its net asset value. It has a unique portfolio which is concentrated on London's West End. The area has a track record of robust performance compared to other locations across the UK, with large visitor numbers and improving transport links meaning that demand is likely to remain robust. Since the supply of property in the area is constrained, rental values may continue to rise.

Although Brexit and global macroeconomic fears could remain in place over future months, a sound balance sheet may allow the business to capitalise on weaker asset prices. As a result, it could deliver recovery potential in the long run.

Growth potential in the heart of London's West End

Although the UK economy may be facing an uncertain period, the West End could offer a relatively resilient outlook. It has a track record of outperforming the rest of the UK economy during challenging periods. As the most visited city in the western world, with over 19 million visitors per year, London's economy could prove to be more robust than other parts of the UK. Since tourism numbers are due to rise by 3.5% per annum through to 2025, the prospects for the region appear to be positive over the long run. Shaftesbury's 600 buildings across 14.5 acres provide it with the opportunity to capitalise on the city's future potential.

The opening of the Elizabeth Line could increase visitor numbers to the West End. It is set to boost capacity on the London transport network by around 10%, with Shaftesbury being well-positioned to benefit. The bulk of its portfolio is within walking distance of Tottenham Court Rd and Bond Street stations, which are Elizabeth Line hubs that are expected to cater to a combined 200 million passengers per year by the mid-2020s. The opening of the Elizabeth Line has been delayed several times, but is now expected to take place in autumn 2019.

Since the supply of properties in the West End is severely limited by planning restrictions, the company's

"GIVEN THE HIGH DEMAND AND LIMITED SUPPLY OF WEST END PROPERTY, FURTHER GROWTH IN RENTS COULD BE AHEAD."

photo.ua / Shutterstock.com

portfolio is not only unique, it is also near-impossible to replicate. Owners of existing properties are reluctant to sell, which helps to further reduce supply. This pushes the value of existing properties higher as demand rises due to the popularity of the seven-days-per-week economy of the West End. This helps to strengthen the company's economic moat, and may provide it with a more robust long-term outlook.

Headwinds and opportunities

Given the uncertain prospects for the UK economy, there is no guarantee that the West End will be immune from asset price falls. Although it may be able to outperform a number of other areas of London and the wider UK, Brexit appears to be causing a growing sense of unease regarding the outlook for the economy. This could contribute to weaker consumer confidence, with the retail and leisure sectors having the potential to be hardest hit if consumers become increasingly price conscious over future months.

Added to this is uncertainty regarding the wider global economy. Threats such as the prospect of a full-scale trade war between the US and China may hold back GDP growth in a number of major economies. Similarly, a US interest rate which could rise a number of times in 2019 may threaten the performance of not just the US economy, but also the wider global economy. This could hurt visitor numbers to London and cause knock-on effects for tenants across the company's portfolio, as well as weaken demand for vacant properties.

Shaftesbury, though, appears to be in a strong position to capitalise on any future weakness for the West End economy. Recent refinancing initiatives have contributed to a fall in the company's blended cost of debt from 4.9% to 3.2%. It has interest cover of 2.6x, while the weighted average maturity of its debt is over 10 years. A loan-to-value ratio of 22.8% suggests that it has the capacity to increase its debt levels, while it has £225 million in undrawn credit facilities available. This could be utilised if asset prices weaken, in order for the company to take advantage of more favourable conditions through which to build on its existing portfolio. Therefore, even if Brexit and global risks contribute to more challenging prospects for the commercial property sector in London, they could create an opportunity for the business in the long term.

"SINCE THE SUPPLY OF PROPERTIES IN THE WEST END IS SEVERELY LIMITED BY PLANNING RESTRICTIONS, THE COMPANY'S PORTFOLIO IS NOT ONLY UNIQUE, IT IS ALSO NEAR-IMPOSSIBLE TO REPLICATE."

A margin of safety and attractive income growth

As highlighted, Shaftesbury has seen its share price decline by 15% in the last year. With its net asset value (NAV) per share increasing by 4.1% in the 2018 financial year, it now has a price-to-book (P/B) ratio of 0.9. This indicates that the stock could offer a margin of safety. Although there is scope for asset prices to fall, the extent of any decline may be limited by the track record of the West End in terms of its resilience. In the long run, it seems likely that London's commercial property prices will recover from any short-term fall as a result of the capital's economic, political and cultural significance.

One area where Shaftesbury may disappoint is with regard to its income prospects. It has a dividend yield of 2%, which is below the current rate of inflation. Dividend growth, though, has occurred in each of the last four years. During that time, shareholder payments have increased at an annualised rate of 6.4% on a per-share basis. Given the high demand and limited supply of West End property, further growth in rents could be ahead. The company's current income has increased at a compound annual growth rate of 5.1% in the last decade, which suggests that over the long run dividend growth may outpace inflation. In the near term, though, the income prospects offered by the stock may be relatively limited.

IR Stone / Shutterstock.com

Political and economic uncertainty in the UK

The political situation in the UK remains very fluid. Between now and the end of March there are likely to be further twists and turns which could include anything from a new Prime Minister being elected, to a new government taking control following a vote of no confidence. There could even be another EU referendum. Whether there is a deal or no deal is also unclear, and all of these issues could impact on investor sentiment. As a result, Shaftesbury's share price may come under further pressure in future months if, as expected, there are further disagreements within the House of Commons on how best to proceed with Brexit.

However, the economic outlook for the UK may be stronger than is currently being priced into a variety of UK-focused stocks. The IMF forecasts a 1.6% rise in UK GDP in 2019, followed by further growth of 1.7% in each of the years from 2020 until 2022. The 3.7% forecast growth rate for the world economy in 2019 may provide a tailwind for the UK during an uncertain period. Clearly, the impact of Brexit is difficult to quantify due to its unprecedented nature. But the key point for investors could be that there are value investing opportunities on offer among UK-focused shares, provided an investor can accept that volatility may increase, rather than subside, in the near term.

Investment appeal for the long term

London's West End not only offers long-term growth potential, it may also prove to be more resilient than the wider UK commercial property market. High demand for retail and leisure space due to London's popularity as a tourism centre could continue to drive rents upward, while a lack of supply as a result of planning constraints may help to support asset values during Brexit.

The planned opening of the Elizabeth Line could further boost footfall in the company's commercial property locations. Two of the Elizabeth Line's main hubs are only minutes away on foot from Shaftesbury's range of retail and leisure space, and this could further strengthen its economic moat, as well as rental growth potential.

Even if property prices fall, Shaftesbury seems to have headroom when it comes to borrowing levels in order to capitalise on available opportunities. It has strengthened its balance sheet and has been able to lower its blended cost of debt.

Having fallen in line with the FTSE 250 in the last year, the stock now seems to offer good value for money. It trades below its NAV per share, which indicates that a margin of safety may be on offer. Although its dividend yield is behind that of the wider index (which yields 3%), dividend growth could continue to beat inflation as a result of a long track record of rental growth.

While there are risks facing the business in the form of Brexit and wider concerns regarding the outlook for the global economy, the stock could offer improving returns in the long run. It has a unique portfolio which would be near-impossible to replicate, while its financial strength and valuation indicate that it has investment appeal for the long term.

About Robert

Robert Stephens, CFA, is an Equity Analyst who runs his own research company. He has been investing for over 15 years and now owns a wide range of shares. His investment style is somewhere between Warren Buffett and Jim Slater. Robert has written for Citywire and The Motley Fool. Outside of investing he enjoys socialising, holidays, swimming and cycling.

BY JOB CURTIS

HOW TO ACHIEVE CONSISTENT INCOME GROWTH

Job Curtis, Fund Manager of The City of London Investment Trust (LON:CTY), explains the strategy behind the Trust's 52-year dividend growth record and how the portfolio is currently positioned with aim of achieving income and capital growth.

The City of London Investment Trust has grown its dividend every year since 1966, which is the longest record of any investment trust. How has this 52-year record been achieved? How is the portfolio positioned for dividend growth going forward?

City of London seeks to have at the core of its portfolio quality companies which are able to grow their profits and dividends consistently. The aim is to find companies that cover their dividends with cash flow and profits and retain enough to invest for the long-term growth of their business. Different industries and companies have varying investment needs. Those in a high growth phase may need to retain a lot of cash for investment. On the other hand, more mature companies may be able to hand back a greater proportion of their retained profits to shareholders as dividends. It is important to check what is being accounted for as profits equates to the cash actually earned by a business. A company needs to generate cash to be able pay its dividend on a sustained basis.

Another important feature to consider is the level of a company's indebtedness. Companies with high debts are more likely to cut their dividends in a downturn because they have to prioritise interest payments. Companies that are in stable sectors are more suitable for leverage which can enhance returns for equity holders. Leverage is less appropriate for companies in sectors that are susceptible to sharp drops in activity.

Discipline, diversification and dividends

In general, we believe that paying and growing a dividend provides a helpful discipline for corporate management against which to judge acquisitions and capital expenditure projects. During the downturn of the oil price in 2015 and 2016, BP and Royal Dutch Shell were able to maintain their dividends by cutting capital expenditure and operating more efficiently.

In terms of portfolio construction, diversification across sectors and stocks is, in our view, helpful for providing consistent dividend growth as well as capital gains. This goes back to the principle of not having 'all one's eggs in one basket.' While a portfolio manager will want to have definite biases within a portfolio, too extreme a position can lead to volatile performance. For example, a portfolio purely of defensive stocks will significantly lag the market during a cyclical upswing of the economy.

The investment trust structure is a definite advantage in delivering consistent dividend growth. While open ended trusts have to distribute all of their income once a year, investment trusts can retain up to 15% which is added to the revenue reserve. The revenue reserve can be drawn down during difficult years for dividends in the equity market enabling an investment trust's dividend to continue growing. In the 27 years since I became City of London's fund manager, we have used the revenue reserves seven times to keep the dividend growing.

"THE CITY OF LONDON INVESTMENT TRUST HAS GROWN ITS DIVIDEND EVERY YEAR SINCE 1966, WHICH IS THE LONGEST RECORD OF ANY INVESTMENT TRUST."

Portfolio breakdown

Looking at City of London's portfolio, we have a balance of key areas with the aim of generating income and capital growth. First, the consumer staples sectors, where the companies are global and have a record of consistent profitability. They sell basic, everyday items and in the long run should benefit from secular growth in emerging markets as vast populations become more affluent. Among City of London's largest ten holding are three consumer staples companies: **Diageo (LON:DGE),** the world leading alcoholic beverages company with brands such as Johnnie Walker Scotch Whisky and Guinness; **British American Tobacco (LON:BATS)** and **Unilever (LON:ULVR).**

"THE INVESTMENT TRUST STRUCTURE IS A DEFINITE ADVANTAGE IN DELIVERING CONSISTENT DIVIDEND GROWTH."

A second key area is the oil sector with **Royal Dutch Shell (LON:RDSA/ LON:RDSB)** – City of London's largest holding – and **BP (LON:BP.),** the third-largest. While the oil price has recently fallen, we believe that the outlook is positive over the next few years given growing demand for oil and natural gas, especially from emerging markets. More importantly, both Royal Dutch Shell and BP have significantly improved the efficiency of their operations in recent years bringing down the oil price needed to cover their dividends.

A third key sector is banks where there are two holdings in City of London's top ten: **HSBC (LON:HSBA)** and **Lloyds (LON:LLOY).** HSBC is a global bank but with the majority of its profits coming from the Asia Pacific region. On the other hand, Lloyds is completely focused on the UK. In our view, both banks have strong capital ratios (reserves versus risky assets) and offer an attractive combination of dividend yield and growth for a relativity modest share price valuation. Banks tend to benefit from rising interest rates, which is favourable for their profitability. HSBC has already seen some benefit from the rise in US rates and if UK interest rates were to continue to go up, it would, in our opinion, be a positive trend for Lloyds.

Bricks and mortar

A fourth important area for City of London is property related being Real Estate Investment Trusts (REITs) and homebuilders. REITs own properties and are able to pass through the rental income to dividends without paying tax, which is an attractive structure for an income fund to own. REITs owned by City of London, such as **Land Securities (LON:LAND)** and **British Land (LON:BLND),** own prime UK office and retail property. Their

"THE UK EQUITY MARKET, IN OUR VIEW, OFFERS AN ATTRACTIVE OPPORTUNITY FOR DIVIDEND INCOME FROM A VARIETY OF DIFFERENT SECTORS."

share prices are currently standing at significant discounts to the valuation of the properties they own which reflects nervousness about the outlook for London offices, which are a major part of their portfolios, ahead of Brexit. In addition, there are specific concerns over structural issues for retail property, but we believe the prime shopping centres owned by Land Securities and British Land are popular destinations and have a prosperous future. The discount ratings appear to offer an opportunity for investors and the REIT sector should be a beneficiary if there is a satisfactory Brexit outcome.

Sentiment towards housebuilders has also been affected by the vicissitudes of Brexit. However, we believe that there is latent demand for home ownership across the UK. The housebuilders owned in the portfolio, which are **Taylor Wimpey (LON:TW.), Persimmon (LON:PSN)** and **Berkeley (LON:BKG),** are well placed to meet this demand with their strong balance sheets and extensive land ownership available for new homes to be built upon.

All in all, the UK equity market, in our view, offers an attractive opportunity for dividend income from a variety of different sectors. The investment trust structure is well placed to aim for consistent annual dividend growth as demonstrated by City of London's fifty-two-year record. It is important to select companies that are both able to cover their dividend and invest enough to grow their profits on a sustained basis.

Risk Warning

Before investing in an investment trust referred to in this article, you should satisfy yourself as to its suitability and the risks involved, you may wish to consult a financial adviser.

Past performance is not a guide to future performance.

The value of an investment and the income from it can fall as well as rise and you may not get back the amount originally invested.

Nothing in this article is intended to or should be construed as advice. This article is not a recommendation to sell or purchase any investment.

It does not form part of any contract for the sale or purchase of any investment.

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BY FILIPE R. COSTA

THE MACRO INVESTOR

MAGIC FORMULA

HOW TO BUILD A VALUE PORTFOLIO FOR 2019

"Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot."

- Joel Greenblatt,
The Little Book That Beats the Market

Getting some leverage

One good way of building an investment portfolio is through a deep analysis of individual shares, by contrasting prices with accounting data and future prospects. But it takes time, effort, and significant resources, making it an almost impossible task for an individual investor. Of course, an investor could always rely on analysts, but research says he shouldn't. Still, there is hope!

A good financial knowledge mixed with statistics may turn the odds in our favour, for a very small cost. With the use of a few, simple, *story-telling* accounting ratios, we can build a strong investment strategy. All we have to do is find a way to pick above-average shares and then allow the market to work in our favour. With the new year upon us, we're going to examine a simple investment strategy that can quite easily be implemented by every individual investor. In its plain vanilla form, it just involves ranking a list of equities using two accounting ratios,

"WITH THE PEAK OF THE ECONOMIC EXPANSION NOW LOOKING LIKE IT IS BEHIND US, VALUE STRATEGIES WILL COME INTO THEIR OWN. THE MAGIC FORMULA IS A GOOD STRATEGY TO BUILD A VALUE PORTFOLIO FOR 2019."

but it can be tweaked and extended to meet different needs. I'm referring to Joel Greenblatt's *Magic Formula,* which aims to select quality shares on the cheap.

Until recently, investors have relied on momentum strategies, as the market has been making new highs for the best part of a decade. But with the peak of the economic expansion now looking like it is behind us, value strategies will come into their own. The *Magic Formula* is a good strategy to build a value portfolio for 2019. So, let's tweak it a little and implement it!

What is the Magic Formula?

After so many years in a bullish mood, shares are running out of steam. While US key indices are still green, that's not the case with European markets, including the FTSE. If growth is trimmed a little and unemployment starts reverting its trend, 2019 may be a year marking the beginning of an early recession phase.

As I mentioned last month, when we move from a late expansion phase to the early contraction phase, quality (high), value (high) and volatility (low) are the factors we want to be exposed to. Last month I built a bottom-up portfolio featuring all these at the same time. This month I will be looking at a simple value strategy developed by Joel Greenblatt, the *Magic Formula*[i], and use it to build two portfolios for 2019.

Originally, the Magic Formula relies on just two accounting ratios, EBIT[ii] Yield and ROTC[iii]. The first ratio attempts to capture cheapness while the second targets quality. These ratios are usually widely available on any online stock screener making it relatively simple for individual investors to apply the *Magic Formula.*

In theory, when selecting shares using a ranking featuring the above ratios, an investor is building a portfolio of cheap companies that are also quality companies. Such a portfolio is expected to, on average, beat the market. But it is important to note that such a strategy doesn't care about the peculiarities of each company, and thus we can never be sure about the reasons leading to a high EBIT yield, without digging deeper. Still, it doesn't mean we have to.

A quantitative strategy that relies on financial statement ratios has one great advantage over digging through qualitative information, which is its objectivity. One of the key drivers of asset bubbles and mispricing is behavioural bias, which is completely eliminated when using a quantitative strategy relying solely on accounting ratios. We just need to work on the part that says it can, *on average, beat the market.* That is achieved by selecting a diversified portfolio of assets and by tightly sticking to the strategy over the years.

Measuring quality

The ROTC ratio is the proxy used by Greenblatt to measure quality. It is computed as the ratio of operating profits (EBIT) to tangible capital employed:

ROTC = EBIT / (Working Capital + Net Fixed Assets)

Greenblatt doesn't use the bottom line earnings from financial statements because they're distorted by tax and debt levels. EBIT is a measure of operating profits, which is a far better proxy for corporate profits than net earnings are. In order to be able to compare companies, we need to exclude leverage and tax structures, otherwise we would come up with an obscure mix of oranges and apples that can't be examined together.

The return on capital used in the *Magic Formula* tries to measure how much operating profit the company is generating with the tangible assets it employs in the business. It is a measure of return on tangible capital employed. Greenblatt excludes intangible assets from the measure. But we won't proceed the same way. Many companies grow by acquiring others. When that happens, the difference between the acquisition price and the accounting value of the acquired business is recorded as goodwill, which is an intangible asset. The acquirer pays this extra because he believes there's more value on what it just acquired than what is reflected on balance sheets. Ignoring goodwill from the calculation will make some businesses appear of better quality than they should. Part of the profit-generating ability of a business is intangible and, of course, worth money, which should always be accounted for. With this in mind, we will be using here a tweaked version of Greenblatt's ROTC. Let's bring intangibles back to the calculation and compute ROCE[iv] instead.

Another important issue about the way return on capital is calculated is the different treatment given to operating leases and own assets. As Phil Oakley[v] points out, operating leases represent off-balance sheet financing that can escape being recorded as capital employed. An airliner renting its planes would look a lot better in terms of return on capital employed than an airline that buys its planes outright – but it shouldn't. I'm adopting Phil Oakley's suggestion of multiplying the annual reported value of operating leases by 7 and discounting the total value at a rate of 7% and adding the resulting value back to capital employed. (A software program like Sharescope/Sharepad automates the process.)

Measuring cheapness

The ratio EBIT yield is a *tweaked* inverted price ratio, which adjusts for different debt levels and tax structures,

as I mentioned above. At the same time, instead of standardising operating profits by market value of equity, it takes into account enterprise value, which corresponds to the value of the whole business:

EBIT Yield = (EBIT / Enterprise Value)

Enterprise value is equal to the total market value of equity plus net interest-bearing debt:

Enterprise Value = Market Value of Equity + Net Interest-Bearing Debt

Again, we will be adopting a version of this ratio that differs from the original Greenblatt EBIT yield. In general, we should include the value to all claimants of an enterprise and not only the claims of debt- and equity-holders. We should include minority shareholders as well. We should also include pensions, in particular at a time that many companies carry large pension deficits on their books. I'm going to follow the suggestion made by Phil Oakley and add back pension deficits to enterprise value.

How to select stocks using the tweaked Magic Formula

If using a good stock screener, like Sharescope or Sharepad, we can easily use ROCE and EBIT Yield to determine the *Magic Formula* rankings. These programs even do this automatically, but I would like to control the output and rank everything on our own.

Here are the necessary steps:

- First, we need to select our universe of equities. It can be all US equities, FTSE 350 equities, or any other we prefer. This is the list from which we will filter and rank shares to get a shortlist.

- Second, we need to exclude Financials and Utilities from our list because these shares require a different valuation approach.

- Third, it may be desirable to exclude shares that are just too small to avoid liquidity problems. Each inves-

"ONE OF THE KEY DRIVERS OF ASSET BUBBLES AND MISPRICING IS BEHAVIOURAL BIAS, WHICH IS COMPLETELY ELIMINATED WHEN USING A QUANTITATIVE STRATEGY RELYING SOLELY ON ACCOUNTING RATIOS."

tor may adjust this filter to his own needs and requirements. For the sake of our selection, I'm requiring market capitalisation to be higher than £250m or $250m.

- Fourth, we should rank shares using ROCE, where higher ROCE corresponds to higher desirability. There are several different ways of doing this. In a similar spirit to [what I did last month](), I suggest ranking shares in a way that higher numbers are attributed to higher ROCE. As an example, let's say that we have a list of 500 shares with a maximum ROCE of 90 and a minimum of 1. Rank numbers would be 500 and 1, respectively. Shares with no ROCE numbers should be eliminated from the list, as we cannot rank them. Departing from the original *Magic Formula*, I'm not using the latest figures for ROCE but instead a 5-year average, as I believe quality is better reflected over time.

- Fifth, we should now do the ranking for EBIT Yield. Higher numbers are again more desirable. Shares with no EBIT yield numbers should also be eliminated from the list. Since annual accounting figures are delivered once a year, the EBIT yield is sensitive to the time of the year we're using it. To minimise this

FIGURE 1 – TWEAKED MAGIC FORMULA PORTFOLIOS

Ticker	Name	Mkt. Cap. (mn)	Sector	EBIT yield (TTM, lease-adj.)	ROCE (5y av., lease-adj.)	Rank Cheapness	Rank Quality	Average Rank
INDV	Indivior PLC	590.5	Pharmac. & Biotechnology	41.3	275.9	434	435	434.5
GFTU	Grafton Group PLC	1,650.2	Support Services	90.4	45.8	436	428	432.0
BKG	Berkeley Group Holdings PLC	4,382.9	Househ. Goods & Home Const.	26.0	30.7	429	415	422.0
BATS	British American Tobacco PLC	62,654.3	Tobacco	29.4	28.3	432	410	421.0
888	888 Holdings PLC	594.9	Travel & Leisure	19.9	42.4	409	425	417.0
BWY	Bellway PLC	3,237.9	Househ. Goods & Home Const.	20.9	23.3	418	389	403.5
LNTR	Lenta Ltd	1,702.4	General Retailers	25.7	21.6	428	378	403.0
FXPO	Ferrexpo PLC	1,095.3	Industrial Metals & Mining	25.3	20.9	427	375	401.0
PSN	Persimmon PLC	6,268.1	Househ. Goods & Home Const.	20.7	22.8	417	385	401.0
RDW	Redrow PLC	1,814.6	Househ. Goods & Home Const.	22.3	20.2	422	368	395.0
ABBY	Abbey PLC	275.8	Househ. Goods & Home Const.	23.7	18.9	425	363	394.0
PHTM	Photo-Me International PLC	398.5	Travel & Leisure	13.2	28.1	376	409	392.5
SEPL	SEPLAT Petroleum Devel Co PLC	777.2	Oil & Gas Producers	37.6	17.9	433	351	392.0
CRST	Crest Nicholson Holdings Ltd	874.3	Househ. Goods & Home Const.	22.7	18.3	424	355	389.5
CAML	Central Asia Metals PLC	373.1	Mining	15.0	21.8	393	379	386.0
0OQQ	Infotel SA	271.8	Software & Computer Services	11.6	30.3	359	413	386.0
HAS	Hays PLC	2,148.6	Support Services	11.7	27.7	360	407	383.5
PAY	PayPoint PLC	582.2	Support Services	10.2	48.8	333	430	381.5
TW.	Taylor Wimpey PLC	4,507.1	Househ. Goods & Home Const.	20.0	17.2	411	343	377.0
STHR	SThree PLC	365.7	Support Services	11.4	25.7	353	398	375.5
GOCO	Gocompare.com Group PLC	315.9	Media	8.9	91.9	301	434	367.5
WIZZ	Wizz Air Holding PLC	3,014.2	Travel & Leisure	16.3	15.9	398	333	365.5
NXT	Next PLC	6,630.9	General Retailers	9.4	30.4	317	414	365.5
BDEV	Barratt Developments PLC	4,815.5	Househ. Goods & Home Const.	21.1	14.8	419	311	365.0
CSP	Countryside Properties PLC	1,317.1	Househ. Goods & Home Const.	14.5	15.9	388	333	360.5
					Universe of Stocks: 436			
DHI	DR Horton Inc	13,899.5	Househ. Goods & Home Const.	169.7	138.0	2139	2135	2,137.0
PDLI	PDL BioPharma Inc	439.4	Pharmac. & Biotechnology	61.4	53.6	2137	2122	2,129.5
NHTC	Natural Health Trends Corp	249.1	Househ. Goods & Home Const.	29.6	92.0	2125	2133	2,129.0
BPT	B P Prudhoe Bay	568.2	Oil & Gas Producers	17.3	16197.5	2082	2139	2,110.5
WLKP	Westlake Chemical Partners LP	729.1	Chemicals	19.0	52.9	2100	2119	2,109.5
KORS	Michael Kors Holdings Ltd	6,445.0	Personal Goods	16.2	54.3	2068	2124	2,096.0
UTHR	United Therapeutics Corp	4,915.3	Pharmac. & Biotechnology	18.5	40.0	2096	2091	2,093.5
BKE	Buckle Inc	955.9	General Retailers	16.7	47.8	2075	2110	2,092.5
HIBB	Hibbett Sporting Goods Inc	291.7	General Retailers	22.7	30.0	2116	2034	2,075.0
BBBY	Bed Bath & Beyond Inc	1,709.1	General Retailers	26.0	27.7	2120	2010	2,065.0
MIK	Michaels Companies (The) Inc	2,796.7	General Retailers	12.9	61.5	1984	2129	2,056.5
PETS	PetMed Express Inc	487.3	Food & Drug Retailers	13.6	42.5	2008	2101	2,054.5
THO	Thor Industries Inc	3,182.9	Travel & Leisure	21.9	23.6	2115	1960	2,037.5
GME	GameStop Corp	1,380.9	General Retailers	60.4	22.6	2136	1937	2,036.5
LYB	LyondellBasell Industries	33,842.8	Chemicals	14.8	29.6	2043	2027	2,035.0
EGOV	NIC Inc	854.1	Software & Computer Services	11.9	57.5	1939	2128	2,033.5
CINR	Ciner Resources LP	457.2	Mining	16.8	24.3	2077	1970	2,023.5
AGX	Argan Inc	677.7	Const. & Materials	12.3	39.8	1955	2090	2,022.5
PINC	Premier Inc	2,464.9	General Retailers	22.9	22.2	2117	1926	2,021.5
TPH	TRI Pointe Homes Inc	1,761.9	Househ. Goods & Home Const.	12.4	36.9	1961	2080	2,020.5
GPS	Gap Inc	10,531.4	General Retailers	13.1	31.6	1989	2050	2,019.5
TUP	Tupperware Brands Corp	1,732.9	General Industrials	13.5	29.8	2003	2029	2,016.0
MCFT	MasterCraft Boat Holdings Inc	444.4	Travel & Leisure	11.0	51.6	1902	2117	2,009.5
FL	Foot Locker Inc	6,259.5	Personal Goods	13.5	27.9	2003	2013	2,008.0
MU	Micron Technology Inc	45,921.3	Technology Hardware & Equip.	31.8	20.8	2128	1886	2,007.0
					Universe of Stocks: 2139			

Source: Sharescope, Own Calculations

"WHILE THESE PORTFOLIOS ARE NOT SURE BETS, THEY ARE STATISTICALLY EXPECTED TO, ON AVERAGE, BEAT THE MARKET."

problem, I'm using TTM figures for this ratio.

- Sixth, we compute the average ranking from the previous two numbers and sort shares from highest to lowest. The highest numbers correspond to the shares that have the best mix of ROCE and EBIT yield.

- Seventh, it is time to build our portfolio. This part is of particular importance because we need to select a sufficient number of equities. Greenblatt advises carrying something between 20 to 30 shares. To minimise the effects of having to buy and sell 20 to 30 shares at one time, he advises on selecting 5 to 7 shares each quarter until the portfolio is complete, which should happen in nine months' time. However, given our goal of building a portfolio for 2019, we will be selecting everything at once. Let's go for the mid-point and select 25 shares.

Implementing the Magic Formula strategy

We now have everything to implement our strategy. All we need is to take a few decisions regarding the investment universe, number of shares to select and weights attributed to them. For the sake of our goal, I will use two different universes: UK shares and US shares.

Figure 2 – Portfolio Statistics

Universe	Median. Mkt. Cap. (mn)	Median EBIT yield (TTM, lease-adj.)	Median ROCE (5y av., lease-adj.)
UK	1,317.1	20.7	23.3
US	1,709.1	16.8	39.8

Source: Sharescope, Own Calculations

After applying the industry filters and requiring EBIT yield and ROCE to be available, our universe of investible assets is 436 shares from the UK and 2,139 shares from the US. After ranking the shares in both lists, we then select 25 from each. Figure 1 shows the final lists while figure two shows a few statistics about the median values for the portfolios. Our UK portfolio has a median market capitalisation of £1,317m which is similar to the median value of $1,709m (£1,340m) for the US. The median EBIT yield is slightly higher in the UK while the median ROCE is significantly higher in the US. Regarding weights, the common choice is to equal-weight each share but investors may adapt this to suit their own goals. Another option would be to use market capitalisation weighting, attributing a larger weight to larger capitalisations.

Final Thoughts

Behavioural biases are the worst demons an investor needs to fight to properly select an investment portfolio. While digging deep into a company's statements may uncover useful information it usually adds subjectivity to the investment process. Often, keeping things simple and allowing a role for maths and statistics is the best route to follow.

A few years ago, Joel Greenblatt unveiled one of the simplest strategies to pick value stocks, which is particularly useful at a time when the market is rotating from momentum and growth to quality and value. With the use of just a few indicators widely available from online screeners and simple investment software, we shortlisted 25 UK and 25 US stocks to play the value theme in 2019. While these portfolios are not *sure bets*, they are statistically expected to, on average, beat the market.

I wish you all a very Happy New Year and I am looking forward to an interesting investment year, one that will be challenging, as the bull market is cooling. I leave you with a few words of wisdom from David Dreman:

> *"Patience is a crucial but rare commodity."*

About Filipe

Filipe has been a contributor to Master Investor since the earliest years. His specialisation is monetary policy, macro issues and behavioural finance where he allies the practical experience of several years of trading with academic credentials. Filipe in fact teaches courses on Financial Markets and Monetary Economics at the University of Oporto Faculty of Economics, helping traders maximise profits and better manage risk.

i Joel Greenblatt explains his ***Magic Formula*** strategy in "The Little Book That Beats The Market". He later updated the book by publishing "The Little Book That Still Beats The Market".
ii EBIT stands for earnings before interest and taxes.
iii ROTC stands for return on tangible capital employed.
iv ROCE stands for return on capital employed.
v Phil Oakley explains the problem in "How to Pick Quality Shares: A Three-Step Process for Selecting Profitable Stocks".

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

BREXIT

A GUIDE FOR THE PERPLEXED

I am writing this the week before Christmas whereas you will be reading this in early January. So events may have overtaken me. But here goes: in the middle of December the political situation in the UK was so uncertain that the outcome of the Brexit process could have gone one of four ways. The possible outcomes were: Mrs May's deal, no-deal, Norway or Bremain. Which was more likely?

The vote on the Withdrawal Agreement (that's the May-Barnier deal published in mid-November) did not take place on Tuesday, 11 December, as planned. As a direct consequence of postponing that vote Mrs May was challenged in a vote of no-confidence by Tory Ultras (that's the roughly 100 Tory MPs who coalesce around the *European Research Group* (ERG)).

In the event, Mrs May survived by 200 votes to 117 on 13 December. That meant that, excluding the "payroll vote" of some 180 MPs who are ministers or officers of the crown, most Tory backbenchers actually voted against their Leader. Under Conservative Party rules, however, Mrs May only required an absolute majority of MPs to back her and, having survived, she cannot be challenged again for 12 months, despite the feeling before Christmas that her personal authority had been compromised.

So, barring some kind of coup (as I submit this Labour has tabled a no-confidence motion), it will be Mrs May who will steer us through Brexit which is scheduled to take place at 23:00 hours on 29 March 2019. But what are the chances that Brexit will be postponed or even reversed altogether? And if it does take place – which type of Brexit will it be?

And who will be the winners and losers in the corporate world? Given that the outlook for global stock and bond markets is not particularly encouraging in 2019 – Brexit aside – most of the risk is on the downside. As I write during the week before Christmas global stock markets are falling and retail stocks are being hammered – but not because of Brexit. There may, however, be some canny players who can profit in a time of uncertainty.

"THE NOTION THAT ALL MRS MAY MIGHT HAVE TO DO NEXT WAS *TO GET ASSURANCES ABOUT THE BACKSTOP* FROM HER FELLOW HEADS OF GOVERNMENT IN EUROPE WAS ALWAYS FAR-FETCHED."

Mrs May's Withdrawal Agreement

If you have been penguin-watching in Antarctica these last two months you may have missed some political drama back home.

It was during the afternoon of Tuesday, 13 November that the news flashed up on our screens that a Brexit deal had been struck between the UK Government and the EU's negotiating team led by Michel Barnier. Mrs May emerged from a marathon five-hour cabinet meeting on the evening of the following day to announce that the cabinet was on-side. Brussels announced there would be an exceptional summit on 25 November to endorse the deal – which it duly did.

The first cabinet resignations came that Thursday morning: significantly that of Dominic Raab, the Brexit Secretary – the man who was supposed to have negotiated the deal. (We now know that Mr Raab had been kept in the dark by the PM – as had his predecessor, Mr Davis.) Mr Raab was quickly followed out of cabinet by Work and Pensions Secretary Esther McVey. A further half dozen or so junior ministers resigned subsequently.

Mrs May then began a series of statements to the House of Commons, all of which were met with hostility from all sides. What emerged was that the deal, if ratified, would entail that the UK would remain *inside* the EU Customs Union, not just for the transition period up to December 2020, but indefinitely until such time as a Canada-style trade agreement was concluded between the two sides. And even then, the "Irish backstop" would determine that the UK could only leave the Customs Union with the consent of the EU...otherwise there would have to be a customs border down the Irish Sea.

Until such point, Britain would have to conform to all EU rules while having no say whatsoever on their formulation. On the plus side (from the Brexiteers' point of view), freedom of movement was to end and the UK would be able to disentangle itself from the Common Agricultural Policy (CAP), the Common Fisheries Policies (CFP) and the European budgetary cycle after the transition period. There was no guarantee that British fishermen would be able to fish in British waters without the competition of their European counterparts – that would be determined later. On the minus side (again from the Brexiteers' point of view), during the transition period, the ECJ would retain jurisdiction over UK laws.

John Redwood MP wrote in his diary on 14 November, speaking for about 100 plus Tory MPs:

> *This is a bad deal. The government should drop it now. Parliament is unlikely to pass the necessary legislation for it. I will vote against were they to try. If we can't get a good future partnership before we pay them any extra money, why would we get one once we have signed away the cash?*

The debate on the *meaningful vote* on the Withdrawal Agreement began on 05 December. It was in its fourth day, on Monday, 10 December when the vote was pulled. This is what Mrs May told the House of Commons in a statement that day:

> *I have listened very carefully to what has been said, in this chamber and out of it, by members from all sides. From listening to those views it is clear that while there is broad support for many of the key aspects of the deal, on one issue – the Northern Ireland backstop – there remains widespread and deep concern. As a result, if we went ahead and held the vote tomorrow the deal would be rejected by a significant margin.*

Now it is true that a large majority of the 100 plus prospective Tory dissenters – not to mention the 10 DUP members – were exercised by what was effectively an EU veto on the UK *ever* leaving the Customs Union unless it *de facto* ceded sovereignty over Northern Ireland to the EU. But the *backstop* was by no means the only reason why to ratify this deal would have been an act of supplication.

For a start, there would have been no possibility of making trade deals which gave third states preferential treatment over the EU itself, even after the

Alexandros Michailidis / Shutterstock.com

The evolution of the European Union

The European Union (as it has been called since the Treaty of Maastricht, 1992) – or the European Economic Community (EEC) as it was originally called – came about a decade or so after the foundation of the UN at a time when Europe was still rebuilding after the devastation of World War II (WWII). Britain was not a signatory to the Treaty of Rome (25 March 1957) which brought the EEC into existence. The original six were: France, West Germany (Germany was split between the capitalist west and the communist east), Italy, the Netherlands, Belgium and Luxembourg. Five of those nations had been occupied by Nazi Germany in WWII – still a very recent memory.

Britain, Ireland and Denmark joined the EEC in 1973. Norway was planning to accede at the same time but its people voted to stay out in a referendum. Greece joined in 1981; Spain and Portugal in 1986. East Germany (the DDR) acceded to the EU when Germany was finally re-united on 03 October 1990. Sweden, Finland and Austria acceded in 1995.

The former Eastern Bloc countries: Poland, the three Baltic States (Estonia, Latvia and Lithuania), Slovakia, the Czech Republic, Hungary and Slovenia joined on 01 May 2004 – as did the Mediterranean island states Malta and Cyprus. Bulgaria and Romania acceded in 2007. Croatia was the most recent recruit in 2013.

Britain is not the first country to leave the EEC/EU. Algeria, which was a part of France until it achieved independence in 1962, left immediately thereafter. Also, Greenland, a Danish dependency, having achieved home rule from Denmark in 1979, withdrew from the EU in 1985 but remained subject to a number of EU treaties.

A number of countries have tried to join the EU but negotiations have run into the sand. Morocco was rejected in 1985, though apparently it still aspires to join. Turkey has been a candidate member of the EU since the mid-1980s but no one now believes that it will become a full member and its desire to become one has dimmed. Montenegro and Serbia are currently officially negotiating to join but in the last two years Serbia has pivoted towards Russia.

point where a Canada Plus-style trade agreement were agreed – and even if no backstop were to come into play. This is because the Withdrawal Agreement forbids the UK from negotiating tariffs (import duties) lower than those obtaining on EU goods.

Labour made clear that it was going to vote the deal down. Not because of the backstop – but rather because the Labour leadership believed that they *could get a better deal.* How they might achieve that remained unclear. As the *Daily Telegraph*'s Juliet Samuel explained,[i] Labour MPs like Hilary Benn complain on the one hand that they don't like the deal because the backstop is of indeterminate duration. And on the other they complain that the deal is unacceptable because it doesn't tie Britain into the Customs Union permanently. Or, Yvette Cooper MP said that she didn't like the deal because it didn't guarantee access to the EU's security databases. Then she admitted that Mrs May had been trying to achieve that but mocked her for being rebuffed. Labour does not come out of this chapter with much dignity.

So the notion that all Mrs May might have to do next was *to get assurances about the backstop* from her fellow heads of government in Europe was always far-fetched. There would have to be a substantive review of the mechanism by which the backstop triggered. *Assurances* were never going to be enough.

"WHAT MAKES THE TROPE OF THE IRISH BORDER EVEN MORE ABSURD IS THAT ONLY A VERY SMALL PROPORTION OF THE REPUBLIC'S EXPORTS ACTUALLY CROSS THAT BORDER."

Frau Merkel listened politely to Mrs May in Berlin on 11 December and then trotted out the tired formula that Brexit negotiations were a matter for Monsieur Barnier and his team – and that individual heads of government (even the *Bundeskanzler*), could do nothing to interfere. Similarly, Mrs May's appeal for help to the assembled EU leaders in Brussels on 13 December fell on deaf ears. Herr Juncker accused her – much to her chagrin – of making *nebulous* demands…

The issue of the Irish border

I don't really recall the matter of the Irish border having been discussed during the referendum campaign of 2016. But since the UK withdrawal negotiations began in June 2017 the Irish border has emerged as *the* key factor in shaping a final agreement. The EU negotiating machine – whose key players were Michel Barnier, Martin Selmayr and Sabine Weyand – Federalists to a man and woman, and lawyers all – came up with what I call *the trope of the Irish border.*

This is the idea that it would be entirely unacceptable for a farmer from the Republic, driving a consignment of lamb or milk from County Monaghan to County Armagh, to fill out a customs declaration online. (Even though he has to submit a VAT return online as things stand today.) Why? Because that would constitute a "hard border" which – so it is argued – would be a flagrant violation of the Good Friday/Belfast Agreement (1998). And yet, as I understand it, there is nothing in the

The Customs Union

The Customs Union is a fundamental mechanism of the European Economic Community (EEC) as established under the Treaty of Rome in 1957 and, since the Treaty of Maastricht (1993), by the European Union (EU). No customs duties are levied on goods bought and sold within the Customs Union. Unlike a free trade area, members of the Customs Union impose a common *external tariff* on all goods entering the EU from third-party states.

Such tariffs or import duties are collected by the governments of the member states and paid over to the EU less an administration fee of about ten percent. A precondition of the Customs Union is that the European Commission negotiates for, and on behalf of, the EU as a whole in all international trade deals and occupies a single seat at the World Trade Organization (WTO). Member states have no competence in trade negotiations individually whatsoever.

Turkey has access to the tariff-free exchange of some goods via its membership in the EU–Turkey Customs Union (1995). Similarly, Ukraine enjoys mostly tariff-free trade in goods under the Ukraine-EU Association Agreement (2014). The EFTA countries are not inside the EU Customs Union.

One of the curious effects of the Customs Union is that most of us, when we go shopping at the supermarket, have no idea which goods are subject to import duties and which are not. Suffice to say that, if the UK were to leave the Customs Union, those delicious Kenyan pineapples would be about ten percent cheaper while those Dutch (hydroponic) sweet peppers would be ten percent dearer. It is not unimaginable that we might be able to reconfigure our supply lines accordingly.

Good Friday Agreement about customs arrangements. Whatever, the EU negotiating gambit worked.

What makes the trope of the Irish border even more absurd is that only a very small proportion of the Republic's exports actually cross that border. Most Irish exports to the UK are shipped from Rosslare to Fishguard (Pembrokeshire) or from Dublin to Holyhead (Anglesey). Irish trucks bound for Europe tend to go Dublin-Holyhead and then Dover-Calais. There are also freight ferry links from Rosslare to Roscoff and Le Havre in France.

Moreover, only about 27 percent of Northern Ireland's exports are sold to the Republic of Ireland[ii] while the rest-of-UK remains Northern Ireland's biggest market by far. So the volume of goods crossing from Belfast to Liverpool and from Larne to Stranraer (Dumfries & Galloway) is much bigger that the volume of goods crossing the Northern Irish border. If there were to be a customs border between Northern Ireland and the UK that would be much to Northern Ireland's disadvantage.

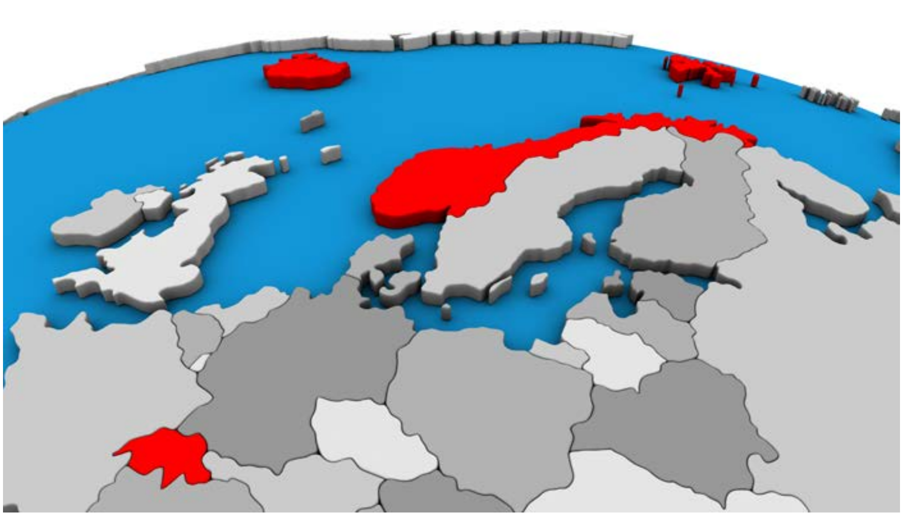
The Norway Option

The chattering classes have been talking about a pivot towards the Norway Option, even as a temporary arrangement, as a way of getting out without a *cliff-edge Brexit* – assuming that Mrs May's deal will not get parliamentary approval.

A number of distinguished commentators have consistently advocated membership of the European Free Trade Area (EFTA) since 2016 – amongst them Dan Hannan MEP and Cristopher Booker of the *Sunday Telegraph*. The oft-repeated argument is that we could join EFTA automatically since we were a member of the trade bloc from its inception in 1960 to the moment we joined the EEC (as it was then) on 01 January 1973.

The EFTA countries[iii] – Norway, Iceland, Switzerland and tiny Liechtenstein – are members of the EU Single Market and of the Schengen Area, but they are *not* in the EU Customs Union. That means that they have to harmonise their commercial regulations with those of the EU, on which they are consulted, though they have no direct input into their design. They enjoy bor-

"A NUMBER OF DISTINGUISHED COMMENTATORS HAVE CONSISTENTLY ADVOCATED MEMBERSHIP OF THE EUROPEAN FREE TRADE AREA (EFTA)."



der-free travel to Schengen states (unlike the UK and the Republic of Ireland) and they are committed to the *four freedoms* – of goods, services, capital and labour (the latter being termed *freedom of movement*). However, there is a mechanism – akin to the *emergency break* so desired by Mr Cameron – according to which they can limit migration from EU states in certain circumstances. Most importantly, since they are not subject to the tariffs agreed under EU trade treaties, they are able to make free trade agreements (FTAs) with third-party states.

Norway is neither in the Common Agricultural Policy (CAP) nor the Common Fisheries Policy (CFP). Norway had two referendums on whether to join the EEC/EU – one in 1972 and another in 1994. In both referendums the metropolitan areas voted for EU membership but the coastal communities – Norway has one of the largest fishing industries in Europe – were opposed. Norway jealously preserves its fish-rich territorial waters for Norwegian fishermen alone. There are many British fishermen, not least in Scotland, who envy that.

The *Daily Telegraph* reported on 01 December that eight cabinet ministers – including Chancellor Hammond – had discussed a "Norway Plan B" given the negligible chance of the May-Barnier Withdrawal Agreement passing through the House of Commons. According to the report, these cabinet ministers believe that the Norway model could win the support of 70 Labour MPs, the DUP and even some SNP MPs.

The *Norway-plus* idea advanced by Nick Bowles MP and others is that we would be out of the political institutions of the EU and no longer bound by the mantra of *ever-closer-union* – but that we would remain in the Customs Union temporarily. We would not be subject to the ECJ. We would have to make financial contributions – as Norway does – but they would be relatively modest. Under the EFTA/EEA framework Britain could suspend free movement if it causes "serious economic or societal difficulties". Supposedly, Liechtenstein has invoked this cause for the last 22 years.

It seems that the EFTA members would have no objection to our membership. However, the EU would oppose it as it would erect a supposed "hard border" in Ireland. (The Republic would be in the Customs Union but Northern Ireland outside.) Once again, the wretched trope of the Irish border trumps all.

There are arguments against the Norway option on both sides. The Bank of England (a bastion of Remain) thinks that the City could be disadvantaged since we would be a rule-taker (as indeed we would be under Mrs May's deal). Brexiteers, like Steve Hilton, argue that *not even Norway likes Norway.*

No-deal

New terminology evolved at the end of 2018 to describe various no-deal scenarios. *Accidental no-deal* means that we muddle through the late winter and spring and then wake up on 30 March to find that trucks cannot cross from Dover to Calais because they do not have the right paperwork – and no one on either side of the Channel knows what the correct paperwork looks like.

Mitigated or managed no-deal means that, come the day, truck drivers will be equipped with all the necessary documentation and that customs checks on both sides would be conducted by officials expeditiously.

The Single Market

The European *Single Market, Internal Market or Common Market* was only finally achieved on 01 January 1993. It guarantees the free movement of goods, capital, services, and labour – the "four freedoms" – within the European Union (EU). The single market encompasses the EU 28 member states (including the UK), and has been extended, with exemptions, to Iceland, Liechtenstein and Norway through EFTA and to Switzerland through bilateral treaties.

A number of potential EU accession candidates have *Stabilisation and Association Agreements* with the EU, which allow for limited participation in selected sectors of the Single Market. These include Albania, Bosnia-Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia. In addition, through three individual agreements on a *Deep and Comprehensive Free Trade Area (DCFTA)* with the EU, the former Soviet states of Georgia, Moldova and Ukraine have also been granted limited access to the Single Market in selected sectors.

In principle, the UK could take up its own seat at the WTO in Geneva on Monday, 01 April 2019. From that day onwards the UK could endeavour to negotiate a free trade agreement with the EU (which is the stated intention of the Political Declaration) as a WTO state – dealing directly with the world's largest trading bloc. Since both sides would start from a position of enjoying identical regulatory regimes (and the UK would not seek to modify regulations for its own sake) that task should be completed much more swiftly than, for example, the EU-Canada FTA which was signed in 2016 after seven years of wrangling.

"ALL THIS BEGS THE QUESTION OF WHETHER A WITHDRAWAL AGREEMENT IS NECESSARY AT ALL."

All this begs the question of whether a Withdrawal Agreement is necessary at all. When the British Empire was dismantled in a kind of closing-down sale during the 1950s and '60s, there were no withdrawal agreements – just treaties that recorded the change of jurisdiction and the transfer of state assets from the British Crown to the newly independent states. Of course, Britain should meet any outstanding obligations, as should the EU; and, of course, the framework agreements regarding, for example, cooperation in scientific research should be perpetuated wherever possible.

I note, however, that it is Europe that is kicking the UK out of the Galileo Programme – much against its will – not Britain flouncing out. That is not necessarily a bad thing. One of my advisors in the realm of aerospace – an ex-NASA guru – informs me that the UK is better off out of Galileo and pursuing its own alternative system with new partners. A fresh start could incorporate much new technology available since the Galileo system is already out-of-date.

It is true that even the best mitigated no-deal would cause some dislocation in supply chains for the first 3-6 months or so: but that is not necessarily an excessive price to pay for the greater prize – the ability to reshape our trading relations in a way that maximises opportunities *for us.*

Our Japanese friends who have invested heavily in the UK should not fret: tariffs are not really the problem at all as these are generally modest and can be easily budgeted for. The impact of tariffs on the export of Nissan cars will be much inferior to the competitive advantage conferred by the depreciation of the pound since 2016 of around 15 percent. The real issue is that goods should still flow freely – tariffs or not.

Bremain

In the run-up to Christmas there was a groundswell of Remain-oriented sentiment in favour of a second referendum.

On 11 December) Sir John Major (PM 1990-97) declared that Article 50 should be revoked forthwith. The European Court of Justice (ECJ) had ruled the day before that the UK could unilaterally rescind Article 50 without the agreement of the EU-27 – but not in order to stall for time in further tedious negotiations. It is likely, however, that if parliament decided to revoke Article 50 in order to hold a second referendum the Europeans would buy that.

"THOSE WHO ARGUE IN FAVOUR OF A SECOND REFERENDUM – A SO-CALLED *PEOPLE'S VOTE* (AS IF THE FIRST ONE WAS NOT A PEOPLE'S VOTE) – DO SO BECAUSE THEY BELIEVE THAT THERE IS A FIGHTING CHANCE THAT THE 52-48 OUTCOME MIGHT FLIP BACK TO REMAIN."

Those who argue in favour of a second referendum – a so-called *People's Vote* (as if the first one was not a people's vote) – do so because they believe that there is a fighting chance that the 52-48 outcome might flip back to Remain.

John Gomez / Shutterstock.com

There is very little evidence, however, that public opinion has shifted fundamentally on this – as Professor Curtice of the University of Strathclyde occasionally reminds us. Personally, I have encountered many people who voted Remain who are appalled by European arrogance during these negotiations. True, many of us underestimated how difficult it would be to unpick the thousands of agreements that bind the UK to Europe in every domain – but that, in itself, has shed light on the extent to which governments from the 1980s (including Mrs Thatcher's) transferred powers to Brussels without adequate national debate.

For those who advocate the *People's Vote* there are three main questions.

First: on what basis would a second vote be a more legitimate expression of public opinion than the first? Why not hold a third if the desired result is not achieved? We know that this has been a tactic used by the EU elite – for example in Ireland and Denmark. When the French rejected the European Constitution in 2005 the EU just re-packaged it as the Treaty of Lisbon and drove that through anyway.

Second: what would the question be? If it is another binary choice between Mrs May's deal (which Labour opposes) and Remain, then that would surely be unacceptable to Leavers who oppose Mrs May's deal. If it were a three-way choice between No-deal, May-Barnier and Remain, then what merry Hell would be unleashed if the British people, in their infinite sagacity, accorded 33 percent for each option? I contend that *there is no question format which could achieve consensus.* The outcome would therefore be *more* confusion and recrimination.

Third: what does Remain mean? Is it to go back to the balmy days of the *status quo ante bellum?* It is by no means clear that the British rebate and exemption from the Euro and the Schengen Agreement would still be available. On one reading of the Maastricht Treaty (1993) Britain's opt-out from the Euro will expire in 2023. And what about Mr Cameron's *emergency brake* on EU migration negotiated in February 2016? Is that still on the table?

Even more contentious: will we have to sign up to President Macron's European Ministry of Finance with its tax harmonisation agenda? And will the European Army be able to deploy British regiments in conflicts; or to summon Europe's largest aircraft carrier, HMS Queen Elizabeth, at whim?

The UK's arteries of commerce

When people talk about the impact of a no-deal Brexit they usually foresee that there will be *gridlock* in Kent (principally on the M20 and M26 motorways) as the flow of goods between Dover and Calais grinds to a halt. And it is true that most freight transported on wheels passes through Dover, the other ferry routes such as Harwich (Essex) to Hook of Holland and Newcastle-Rotterdam having been downgraded in recent years. But less than 45 percent of our trade is conducted with the EU and less than half of that travels by truck.

The UK now has state-of-the-art deep water container ports at Felixstowe (Suffolk) and at the new London Gateway upstream from Tilbury (Essex). Liquid natural gas (LNG) comes into the Isle of Grain (Kent) and most crude oil imports and chemicals are received at Immingham (Lincolnshire) and at other major refinery sites such as Milford Haven (Pembrokeshire).

As people who live in Kent (like me) know – the French closing the port of Calais is a fairly frequent event. *Operation Stack* – when Kent Police force all trucks to pull over to the hard shoulder on the A20 – has been triggered an incredible 211 times in the last ten years. This is usually because a Leninist French trade union is having tantrums about its *privilèges*... We could do better to re-route much of our Dover-Calais exports to Antwerp and Zeebrugge anyway...

A second referendum is a very bad idea – and talk of Remain-after-all is simple-minded. As I wrote in December, even if you believe we have jumped out of the frying pan into the fire that is not an argument for jumping back into the frying pan.

The long and the short of it...

Of course, things may have changed by the time you read this: but where I am (pre-Christmas) it looks like no-deal is the most likely outcome. The House of Commons will pass as many motions as it likes – like Turkeys registering their moral disapproval of Christmas – but, in the end, it will mean nothing. Come 23:00 on 29 March – Big Ben will chime (or maybe not since it is under renovation – how very British...).

But if I turn out to be right and we shall awake to a no-deal Brexit on 30 March, let me tell you which stocks will bomb...

First and foremost the major German automotive manufacturers will nosedive – that's **BMW (ETR:BMW), Daimler (ETR:DAI)** and **Volkswagen (ETR:VOW)** and **Porsche (ETR:PAH).** In any case, I suspect that there are more scandals to emerge from these privileged players who are part of the deep German state... What is clear is that corporate governance in Deutschland AG is going down the drain...

Then dear old **Rolls Royce (LON:RR.)** will be in the firing line. A senior **Airbus Industrie (EPA:AIR)** exec told me over lunch in France over the summer that they are "losing patience" with the performance of RR's "problematic" Trent 1000 aero-engine. But cut RR some slack: they are supplying that engine, despite problems, to most of the new generation of Boeing 777 Dreamliners. RR will survive – though no thanks to Europe.

Logistics companies like **Stobart Group (LON:STOB)** will come under severe pressure – but, on the other hand, global shippers, especially Chinese ones, like **Evergreen Marine (TPE:2603)** will take up some of the slack when the European blockade begins.

On the long side (as I shall share shortly) I am beginning to think that supermarkets may have been oversold. The pivot away from European foods to home-grown ones could do wonders for margins. I cannot understand why downmarket supermarkets like ASDA (owned by **Walmart (NYSE:WMT)**) stock no organic British pork but instead offer vile Dutch and Danish pork products which have been raised in wretched conditions. If **Sainsbury's (LON:SBRY)** does not do something about that after the proposed merger I shall be wearing a *gilet jaune* at their next AGM.

But Waitrose/John Lewis (private) gets it. I think that one of the big themes of 2019 will be ecology – and if the European blockade against the UK reduces food miles, that will be great for the environment. Any supermarket chain that can correctly claim to have reduced plastic packaging will be kicking at an open goal...

Unfortunately, the stock markets are likely to be quite stressed in 2019 for reasons well beyond Brexit. But then, if you don't like the heat, you can always get out of the kitchen.

About Victor

Victor is a financial economist, consultant, trainer and writer, with extensive experience in commercial and investment banking and fund management. His career includes stints at JP Morgan, Argyll Investment Management and World Bank IFC.

i See Hard Remainers should be careful what they wish for, The Daily Telegraph, Saturday, 15 December 2018, page 21.
ii See ONS at: https://www.ons.gov.uk/businessindustryandtrade/internationaltrade/articles/patternsofnorthernirelandtradebydestinationproductandbusinesscharacteristics/2012to2016
iii The European Economic Area (EEA) is EFTA minus Switzerland.

BY RICHARD GILL, CFA

BOOK REVIEW

THE BEHAVIORAL INVESTOR

BY DANIEL CROSBY

Behavioural finance is one of the most interesting and thought-provoking areas of economics today. Instead of focussing on traditional economic theory, which suggests how humans, or "Homo Economicus", ought to behave in relation to their decisions, behavioural finance attempts to explain *why* investors decide to make the choices that they do. Choices which often don't seem to make any sense – like buying shares in companies in declining industries which look to offer an excitingly high yield but are more than likely to go bust instead.

Under traditional theories, the emotionless, disciplined investor would analyse a stock rationally and objectively, not letting emotions sway their investment decisions. But in the real world a whole range of biases and feelings can affect how we look at our investments and what decisions are made. An estimated 117 such biases have been identified by proponents of behavioural finance as being likely to sway decision-making for the worse.

Along those lines, *The Behavioral Investor* is the latest effort from finance psychologist and wealth manager Daniel Crosby, with the book having the ambitious aim of being the most comprehensive guide to the psychology of asset management ever written. It begins by delving into the mysteries of human nature, key to the underlying mechanisms of how capital markets work, before teaching investors how to apply this knowledge to portfolio construction and go on to improve their returns.

Daniel Crosby, Ph.D, is a psychologist, behavioural finance expert and asset manager who applies his study of market psychology to everything from financial product design to security selection. He has already authored a number of books on his subject of interest and is the founder of behavioural finance focussed investment management firm Nocturne Capital. As well as writing monthly columns for WealthManagement.com and Investment News he has also been named one of the "12 Thinkers to Watch" by Monster.com.

> **"IF YOU FEEL PASSIONATELY ABOUT AN INVESTMENT IDEA, YOU PROBABLY HAVEN'T THOUGHT HARD ENOUGH ABOUT IT."**
> **DANIEL CROSBY**

"THE OVERCONFIDENT HOLD LARGE POSITIONS IN SINGLE STOCKS."

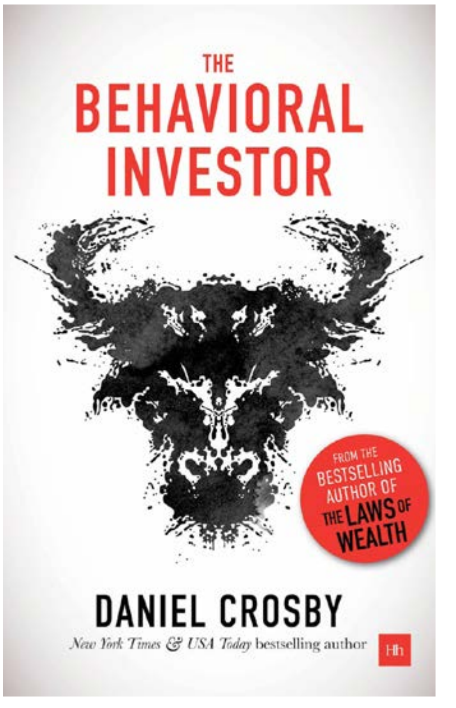
Biased brain

Part One of the book kicks off with an explication of the sociological, neurological and physiological obstacles that humans have to contend with when making investment decisions. After all, there is no understanding markets without first understanding people. On the neurological side, Crosby argues that the human brain, while highly sophisticated, remains pretty much the same in evolutionary terms today as it was 150,000 years ago. But because the complexity of the world in which we live has risen exponentially over the past few hundred years or so, our mental hardware hasn't yet caught up to cope with more intricate things like stock markets. For example, our primitive instinct to take immediate action when faced with a threat forces us to react quickly to avoid danger. But while that might have saved us from being eaten by a lion in the wild, the same instant reaction might not be appropriate in financial markets, where focussing on the long-term can provide much better results.

In Part Two Crosby then moves on to what he argues are the four main psychological tendencies that drive and impact (for the worse) investment behaviour. These are ego, conservatism, attention and emotion, some of which are displayed more by some investors than others – just take a quick look at any small cap stock's bulletin board thread for an example. After this chapter, readers will hopefully have an improved understanding of how their own behaviour affects their decisions, be able to demonstrate more humility and see the world through a more objective lens.

Moving on to Part Three and Crosby builds on the concepts in Part Two, discussing how successful behavioural investors can overcome problems associated with the four traits above and providing practical exercises focussed on making readers a better investor. Those with a problem with ego for example, the tendency toward overconfidence and behaving in ways that maintain feelings of personal competency, could do a number of things. These include checking whether personal "skill" is really down to luck, keeping a log of transactions to monitor true performance and being humble by diversifying assets to protect against a catastrophic and ego destroying decline. Those might be difficult for some bigheads out there, but in the long run should be beneficial for their portfolios.

Finally, Part Four provides details of a Blair-esq "third way" of investing, adding to the traditional passive and active approaches, so that investors can construct behaviourally informed investment portfolios. For the precise details of how to do this you'll have to read the book. But it's worth pointing out at this stage that, while the behavioural finance concepts discussed here are now widely accepted by the finance world, there remains a big gap between the theory and application. It's safe to say that we can all accept humans have faults but it's another thing to put procedures in place to correct them.



Behave yourself

As investment manager Noreen D. Beaman says in the foreword to *The Behavioral Investor,* "...behavioral [sic] mastery is what separates successful from unsuccessful investors." For that reason alone the book is required reading for anyone who is involved in the financial markets, both professional and private alike, as well as any business owner who wants to learn more about human behaviour. Adding to that, Crosby is a master of his craft, a great storyteller as well as an academic, who can explain sometimes difficult concepts in simple terms and support his arguments with thought-provoking and entertaining commentary. Why not make it a New Year's resolution to improve your investing behaviour?

About Richard

Richard Gill is an investment analyst with over a decade's experience of analysing small/mid cap equities. He is the Head of Research at Align Research. Richard qualified with the Chartered Financial Analyst (CFA) designation in 2012 and was awarded PLUS Markets Financial Writer of the Year at the 2008 PLUS Awards. He has been a judge at the Small Cap Awards from 2013 to 2017.

BY TIM PRICE

THE FINAL WORD

USE WHAT WORKS DISCARD WHAT DOESN'T

Daily, my mail box is full of emails, many of which come from well-meaning friends. 'Have you seen this article?' or 'Do you know this guru?' I follow the links as I frantically go from thenewyorktimes.com to financialarmageddon.com and everywhere in between. 'The dollar will rebound', 'Gold is another bubble', 'Buy bonds', 'Sell bonds', 'Pork bellies are undervalued', and so on. I pretend to read some of these writings just so that I can make up something to say should they follow up the email with a telephone call. In an enduring quest for understanding and picking kernels of knowledge, I find myself surrounded in an epochal – and mad – battle of the optimists versus the pessimists.

Honestly, there are intractable and momentous problems which should be the cause of considerable pessimism. But when it comes to action with other people's money – particularly the irreplaceable kind – merely on account of the free advice of a well-known guru who writes for the-world-is-coming-to-an-end.com is complete madness. To follow the advice of an analyst working for a bank that can't even manage its own balance sheet and who is intentionally or accidentally divorced from reality, is madness squared.

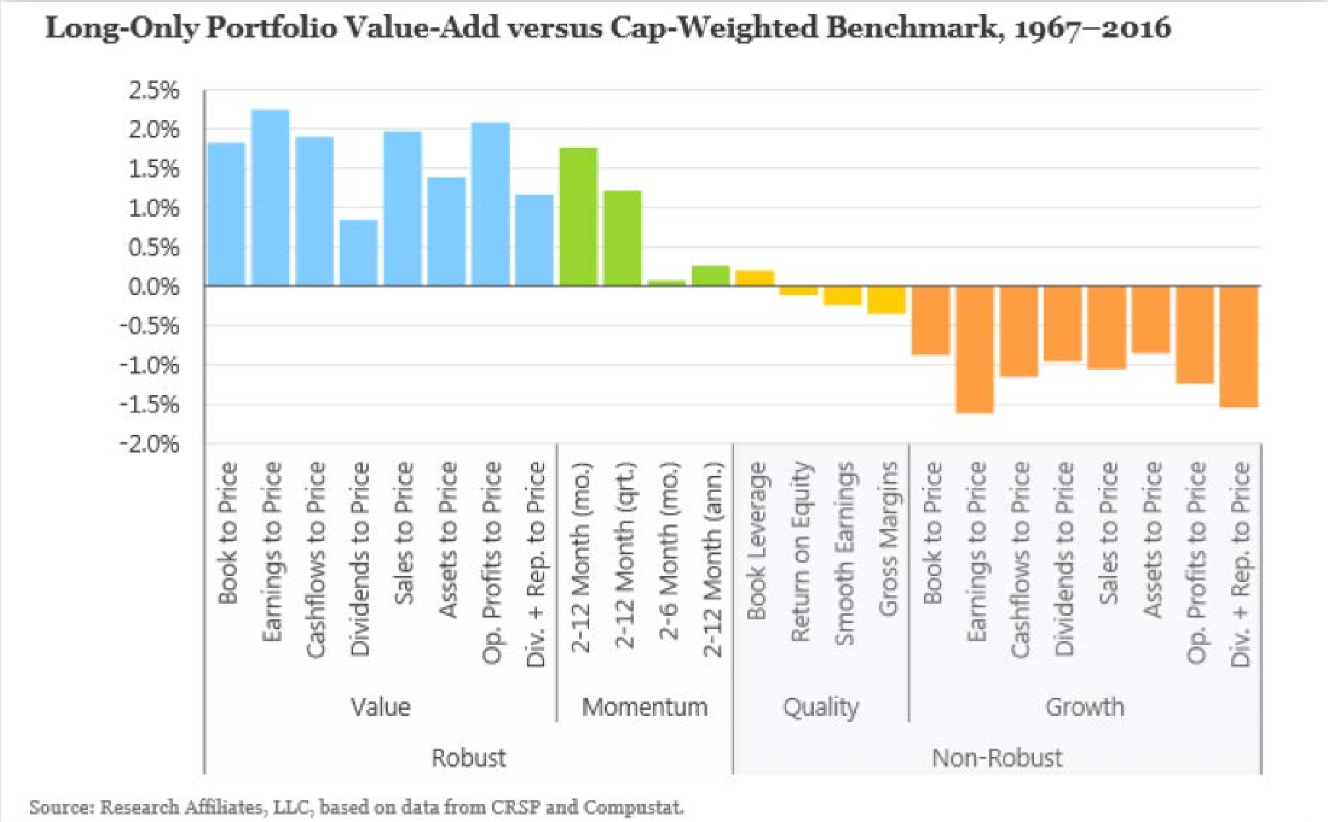
– Asset manager Tony Deden.

First, here's what *doesn't* work. Trying to decode the big macro thesis doesn't work, at least not for me. Warren Buffett may be able to, but as football supporters could doubtless tell us, there's only one Warren Buffett. Even then, Buffett didn't make his fortune by way of macro bets. He made it from disciplined, long term value investing. Expecting either the financial media in general, or higher profile investment gurus in particular, to help us doesn't work either.

No mention of the topic of self-appointed financial gurus could possibly be complete without reference to Jim Cramer, by way of example. On 29 February 2000, Cramer issued the following guidance to his followers at TheStreet.com:

> *You have to throw out all of the matrices and formulas and texts that existed before the Web. You have to throw them away because they*

"$10,000 INVESTED IN THE HIGHEST PRICE/BOOK STOCKS ENDED UP BEING WORTH $267,147. $10,000 INVESTED IN THE LOWEST PRICE/BOOK STOCKS, CONVERSELY, ENDED UP BEING WORTH OVER $22,000,000."



can't make money for you any more, and that is all that matters. We don't use price-to-earnings multiples anymore at [his hedge fund]. If we talk about price-to-book, we have already gone astray. If we use any of what Graham and Dodd teach us, we wouldn't have a dime under management.

Delivering the keynote speech at the 6th Annual Internet and Electronic Commerce Conference in New York, on the same date, Cramer added, in relation to his 10 favourite internet and technology stocks:

We are buying some of every one of these this morning as I give this speech. We buy them every day, particularly if they are down, which, no surprise given what they do, is very rare. And we will keep doing so until this period is over – and it is very far from ending. Heck, people are just learning these stories on Wall Street, and the more they come to learn, the more they love and own! Most of these companies don't even have earnings per share, so we won't have to be constrained by that methodology for quarters to come.

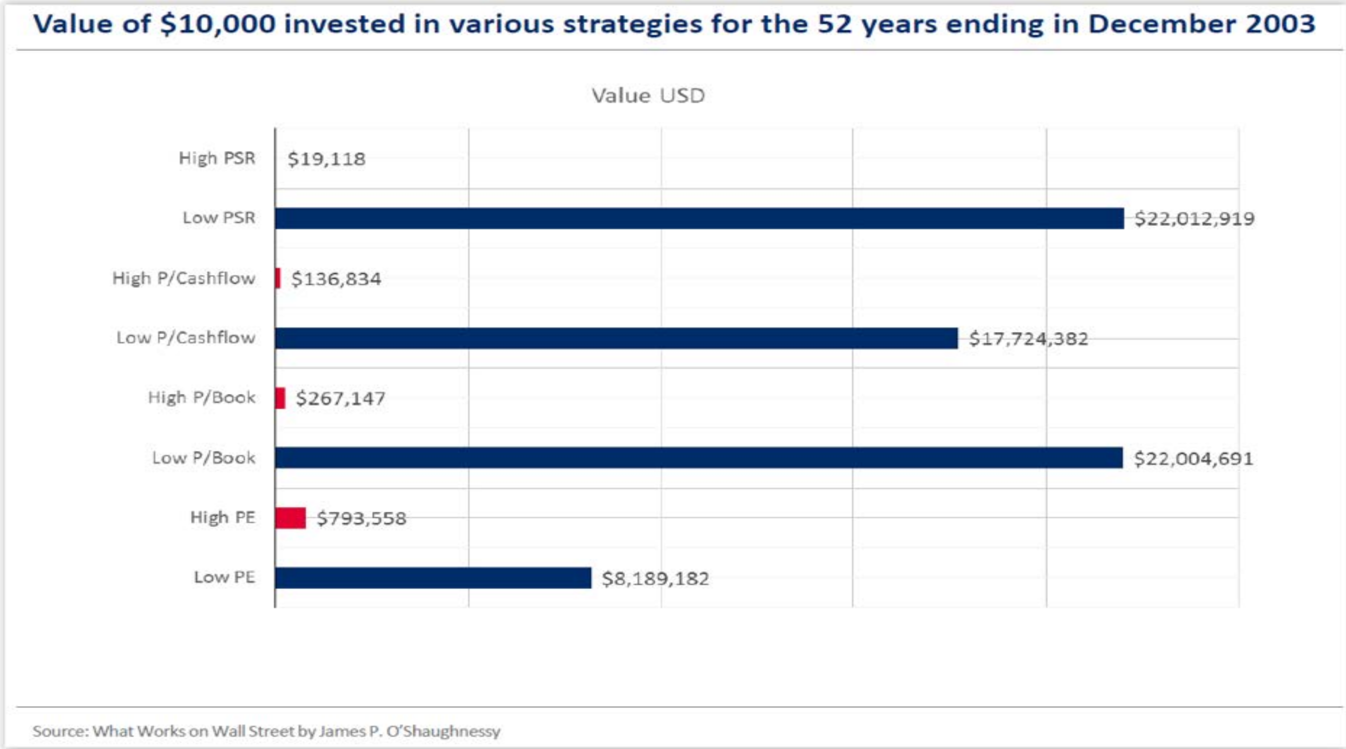
The Nasdaq peaked within a month of this advice and would go on to lose 80 percent of its value over the following two years. Buying internet stocks in 2000 may have felt comfortable, but it wasn't exactly profitable, at least over that subsequent two-year period.

So, what does work? If a recent 50-year period is any guide, the two styles known as 'value' and 'momentum'. US fund managers Research Affiliates crunched the data for the period 1967 to 2016 which are shown below in relation to the S&P 500 index.

'Value' – which I would define in this case simply as buying good stocks cheaply – was the single best performing strategy over the period in question, typically adding value versus the market every year. 'Momentum' – which I would define here as simply following trending stocks – was the next best performing strategy. Interestingly, both 'quality' and 'growth' ended up **destroying** value versus the simple market return.

The next piece of evidence on the part of the prosecution (or is it defence?) is the work done by James O'Shaughnessy in his book *What Works on Wall Street* (the edition I own being the third edition, published in 2005). O'Shaughnessy crunched the data over a similarly extensive period of US stock market history, 1951 – 2003, and analysed the returns from owning the 50 highest and lowest scoring stocks by category (price/sales; price/cashflow; price/book and price/earnings), and then rebalancing those 50 stocks each year. Assuming a starting $10,000 invested in each category, the results are shown below:

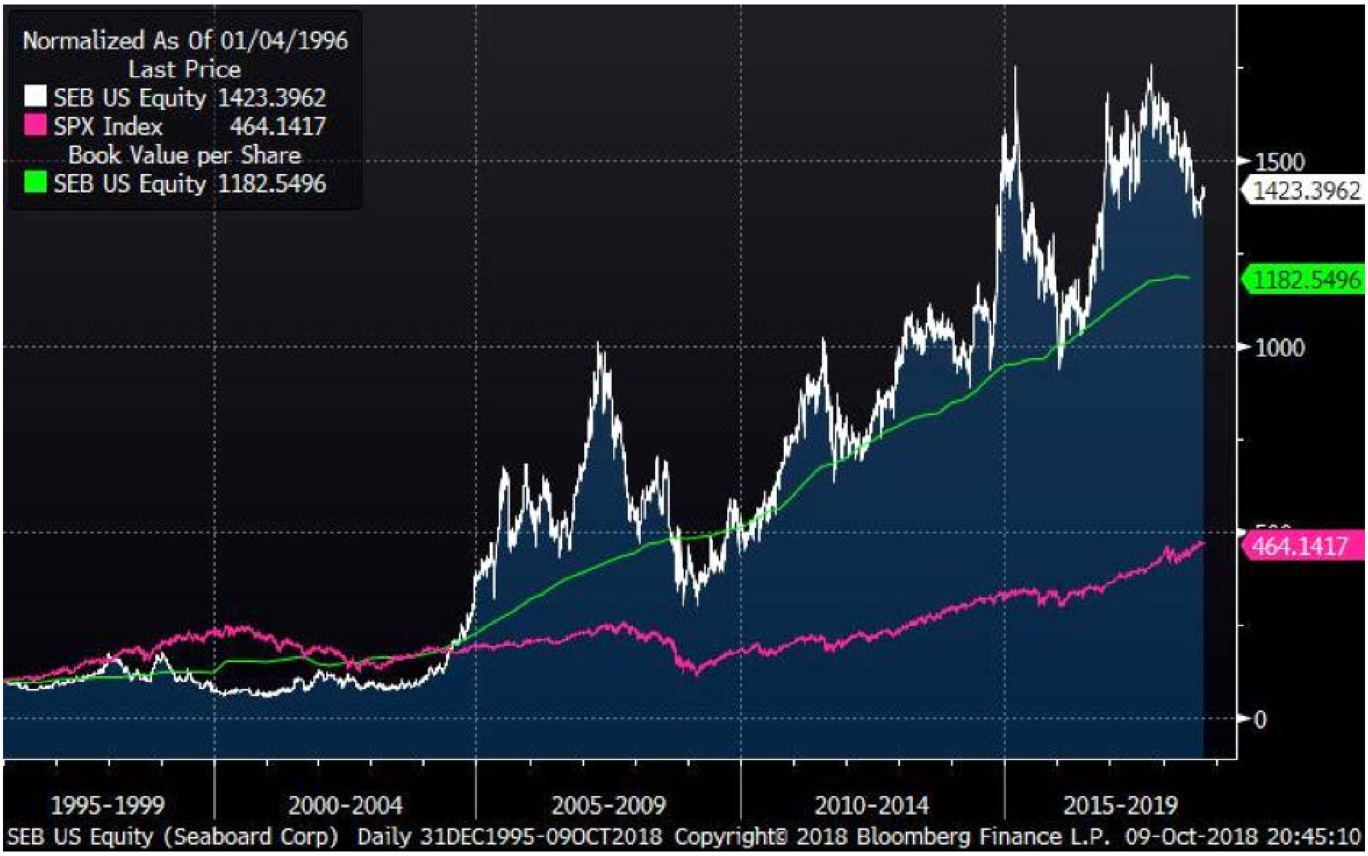
There may be more conclusive proofs of the merits of value investing over growth, at least with regard to the period in question, but I for one haven't seen them. $10,000 invested in the highest price/book stocks ended up being worth $267,147. $10,000 invested in the lowest price/book stocks, conversely, ended up being worth over $22,000,000. There is a legitimate question as to whether the nature of the US economy in particular has changed as a result of new technologies and the capital-light structure of many 'modern' businesses, but there's also a legitimate question as to whether either mean reversion or human nature are somehow profoundly different in 2018 as opposed to in 1948. I think we are the same over-educated apes we've always been. I would add that for some months now, large cap US technology stocks – think the so-called FAANGs – have come off the boil. Since they were pretty much the only sector holding up US equity markets, look out below.



My third chart highlights the relevance of discipline in the stock buying process. It shows the 1995 – 2018 history of Seaboard Corporation (NTSE:SEB), a stock that in the interests of full disclosure I own within my own fund, the VT Price Value Portfolio. Seaboard is a diversified agribusiness which operates internationally and which is part-owned and managed by the Boston-based Bresky family.

The chart shows three distinct lines. The pink line denotes the S&P 500 index, which returned 464% over the period in question. The white line denotes the share price of Seaboard, which has delivered 1423% over the same period. Perhaps most interesting, however, is the green line, which shows the book value per share of Seaboard stock.

Seaboard Corp share price (in white), 1995 – 2018



Source: Bloomberg LLP

The best investment funds in history?

11 Funds - 6 Simplistic Long Term Trend Followers

Notes	Fund	Class/ Share / Program	Manager	Inception	CAGR%	Max D/D	Assets $Mill's	MAR Ratio
	Eckhardt	Standard Prog	William Eckhardt	Jan-87	23.81	29.08	400	0.82
	EMC Capital Management	The Classic Prog	Liz Cheval	Jan-85	23.2	45.16	180	0.51
	Hawksbill Capital Management	Global Diversified	Jerry Parker	Nov-88	22.24	61.78	55	0.36
	Blenheim GL Markets L.P		William Kooyker	Dec-86	22.06%	41.20%	2535	0.54
	Tudor Investment Corp	BVI Global Fund	Paul Tudor Jones	Oct-86	21.76	17.07	9206	1.27
	MJ Walsh	The Standard Prog	Mark Walsh	Sep-85	21.33	43.04	75	0.50
	J.W.Henry and Co.	Financials and Metals Prog	John Henry	Oct-84	21.1	43.6	20	0.48
	Moore Capital	Global Inv Fund, LTD A$	Louis Bacon	Dec-89	20.64	18.45	7200	1.12
	Abraham Trading Company	Diversified Prog	Salem Abraham	Jan-88	20.33	31.96	520	0.64
	Gamut Investments		Bruce Kovner	Jun-86	20.31	13.45	533	1.51
End 08	Berkshire Hathaway	per Share Book Value	Warren Buffet	1965	20.30%	9.60%	?	2.11

Source: Lawrence Clarke Investment Management / Chris Clarke

I think we can fairly infer a number of conclusions from the price data above, including:

1. Selecting the shares of a high-quality business can, albeit only provably with hindsight, deliver market-beating returns.

2. Share price does, at least in this case, tend broadly to track growth in book value per share, albeit in a more volatile way (companies and their boards can clearly control their underlying operations more easily than they can control their share price).

3. While simply buying the shares at any arbitrary point in time has delivered good returns, buying the shares close to, at or below book value has delivered exceptional returns – and with a higher "margin of safety" into the bargain.

There may be more compelling evidence of the merits of buying the shares of good businesses cheaply, but I haven't seen it. An extra facet of Seaboard that makes it unusually interesting to me is that it isn't widely known. To the best of my knowledge, it's not followed by **any** Wall Street analysts.

Having dedicated three charts to 'value', it seems only fair to share a table on the topic of 'momentum'. By 'momentum' here I mean very specifically systematic trend-following, on which topic you can read much more here. A friend of mine, Chris Clarke, crunched the numbers on what could fairly be described as amongst the best investment funds in history.

Chris' criteria might sound somewhat arbitrary, but they were stringent. To make the shortlist, a fund had to have an audited track record going back at least 20 years. Most funds fail to make this cut, primarily because the manager in question either retires or his fund gets closed down or merged into another. Secondly, a fund had to have generated average annualised returns of at least 20 percent. If that sounds like an unchallenging hurdle, only 11 funds made the final cut. (Berkshire Hathaway, it should be noted, a) isn't technically a fund and b) only just made it onto the list, at Number 11.)

Of those 11 funds, fully six of them were simplistic long-term trend-followers.

Global politics today seems unusually nasty and polarised. Perhaps it's always been that way, and we only just noticed. Newsflow largely reflects the partisan identity politics of a widely discredited commentariat and is in any case a gigantic distraction. Only one thing really matters, and that is price. Both 'value' and 'momentum' focus on price, albeit from wholly different perspectives (one being underlying valuation, the other being the direction of the price trend; one requires patience, the other fleetness of trading foot). In a recent interview I conducted with a private investor, the investor in question shares my view that both these (very distinct) strategies can be usefully combined within an investment portfolio.

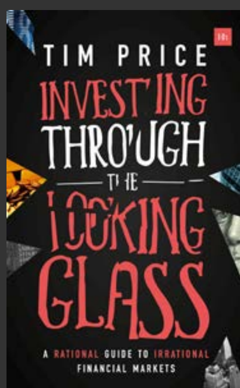
At the end of Trading Places, as the protagonists have taken their riches off to their very own sun-kissed paradise island, Eddie Murphy's character asks butler Denholm Elliott what they should have for lunch: lobster, or cracked crab? Elliott's attractive, erm, protégée responds:

> Can't we have both?

Well, can't we?

About Tim

Tim Price is manager of the VT Price Value Portfolio (www.pricevaluepartners.com) and author of 'Investing Through the Looking Glass: a rational guide to irrational financial markets'.



JANUARY 2019

INVESTOR EVENTS DIARY

EVERY WEDNESDAY

Event:	SR Live
Organiser:	SyndicateRoom
Time:	12:30
Place:	Webinar
Link for tickets:	https://www.syndicateroom.com/events/sr-live

TUESDAY, 29 JANUARY

Event:	Netwealth Investor Evening
Organiser:	Netwealth
Time:	18:30 onwards
Place:	60 Charlotte Street, London W1T 2NU
Link for tickets:	https://www.netwealth.com/events

JANUARY

Event:	UKBAA Medtech Showcase
Organiser:	UKBAA
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Link for tickets:	Email amanda@masterinvestor.co.uk to register interest

TUESDAY, 5 FEBRUARY

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Link for tickets:	Email amanda@masterinvestor.co.uk to register interest

FRIDAY, 22 FEBRUARY

Event:	London Forex Show 2019
Organiser:	Investor Conferences (UK)
Time:	09:30-17:00
Place:	Novotel London West, 1 Shortlands, London W6 8DR
Link for tickets:	Email amanda@masterinvestor.co.uk to register interest

TBC MARCH

Event:	International Women's Day: Female investor meetup
Organiser:	Master Investor
Time:	18:00-21:00
Place:	TBC, London
Link for tickets:	Email amanda@masterinvestor.co.uk to register interest

SATURDAY, 6 APRIL

Event:	Master Investor Show
Organiser:	Master Investor
Time:	09:30-17:00
Place:	Business Design Centre, 52 Upper Street, London N1 0QH
Link for tickets:	https://masterinvestorshow-2019.reg.buzz

TUESDAY, 9 APRIL

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Time:	Email amanda@masterinvestor.co.uk to register interest

TUESDAY, 14 MAY

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Link for tickets:	Email amanda@masterinvestor.co.uk to register interest

TUESDAY, 9 JULY

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Time:	Email amanda@masterinvestor.co.uk to register interest

TUESDAY, 10 SEPTEMBER

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Link for tickets:	Email amanda@masterinvestor.co.uk to register interest

TUESDAY, 10 SEPTEMBER

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Time:	Email amanda@masterinvestor.co.uk to register interest

FRIDAY, 25 OCTOBER

Event:	London Investor Show
Organiser:	UK Investor Events
Time:	09:30-17:00
Place:	Novotel London West, 1 Shortlands, London W6 8DR
Link for tickets:	https://www.eventbrite.co.uk/e/london-investor-show-2019-tickets-53471905910

TUESDAY, 12 NOVEMBER

Event:	London South East Investor Evening
Organiser:	London South East
Time:	18:00-21:00
Place:	Brewers Hall, Aldermanbury Square, London EC2V 7HR
Time:	Email amanda@masterinvestor.co.uk to register interest

MARKETS IN FOCUS

DECEMBER 2018

GLOBAL EQUITIES

Index	Last Month %	YTD%	52-Week Strength
S&P/ASX 200	-0.4	-6.9	
Bovespa	-1.8	15.0	
Hang Seng	-2.5	-13.6	
FTSE 100	-3.6	-12.5	
Russian TSI	-4.8	-7.1	
CSI 300	-5.1	-25.3	
CAC 40	-5.5	-11.0	
Euronext 100	-5.8	-11.2	
IBEX 35	-5.9	-15.0	
DAX Xetra	-6.2	-18.6	
FTSE All-World	-7.1	-11.3	
Dow Jones	-8.7	-5.6	
NASDAQ 100	-8.9	-1.0	
S&P 500	-9.2	-6.2	
Nikkei 225	-10.5	-12.1	

COMMODITIES

Commodity	Last Month %	YTD%	52-Week Strength
Cocoa	11.2	33.1	
Iron Ore	11.2	4.8	
Silver	8.7	-9.6	
Gold	4.6	-1.9	
Palladium	4.3	12.7	
Aluminum	0.0	3.9	
Platinum	-0.4	-14.3	
Copper	-3.6	-18.5	
Sugar (No. 11)	-3.7	-9.3	
Bitcoin	-4.4	-74.3	
Cotton	-8.3	-4.2	
Coffee	-10.1	-16.2	
Crude oil (Brent)	-10.6	-20.9	
Crude oil (Light Sweet)	-11.3	-25.5	
Natural Gas	-34.2	3.4	

FOREX

Pair/Cross	Last Month %	YTD%	52-Week Strength
GBP/AUD	3.7	4.7	
USD/CAD	2.4	8.1	
EUR/USD	1.3	-4.4	
EUR/GBP	1.3	1.2	
GBP/USD	0.0	-5.6	
EUR/CHF	-0.4	-3.7	
USD/CHF	-1.4	1.0	
EUR/JPY	-2.1	-6.9	
USD/JPY	-3.4	-2.7	
AUD/USD	-3.5	-9.7	

CENTRAL BANKS – RATES & MEETINGS

Central Bank	Key Rate	Next	After
Bank of England (BoE)	0.75%	Feb 07	Mar 21
European Central Bank (ECB)	0.00%	Jan 24	Mar 07
Federal Reserve System (FED)	2.50%	Jan 30	Mar 20
Bank of Japan (BoJ)	-0.10%	Jan 23	Mar 15
Bank of Canada (BoC)	1.75%	Jan 09	Mar 06
Reserve Bank of Australia (RBA)	1.50%	Feb 05	Mar 05
Swiss National Bank (SNB)	-0.75%	Mar 21	Jun 13
Banco Central do Brasil (BCB)	6.50%	Feb 06	Mar 20
Central Bank of Russia (CBR)	7.75%	Feb 08	Mar 22
Reserve Bank of India (RBI)	6.50%	Feb 07	

FTSE 350 TOP RISERS

Company	Last Month %	YTD%	52-Week Strength
Fresnillo PLC	14.1	-39.8	
Anglo American PLC	11.6	12.8	
Ferrexpo PLC	11.0	-33.6	
Amigo Holdings PLC	11.0	-1.8	
Indivior PLC	10.2	-72.5	

FTSE 350 FALLERS

Company	Last Month %	YTD%	52-Week Strength
Superdry PLC	-39.5	-76.3	
Stobart Group Ltd	-26.9	-48.7	
Dixons Carphone PLC	-25.7	-39.6	
Senior PLC	-21.1	-27.3	
Wood Group (John) PLC	-20.3	-22.1	

FTSE 350 SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
Industrial Metals	7.3	16.9	
Mining	5.5	-8.8	
Leisure Goods	0.2	34.8	
Beverages	-0.8	2.5	
Support Services	-1.9	-9.3	

FTSE 350 SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
Oil Equip, Services & Dist	-16.7	-18.7	
Automobiles & Parts	-13.6	-10.0	
General Retailers	-13.4	-27.3	
Industrial Transportation	-12.6	-36.1	
Food Producers	-11.5	-22.4	

IA SECTORS RISERS

Sector	Last Month %	YTD%	52-Week Strength
UK Index Linked Gilts	3.5	0.5	
UK Gilts	2.5	0.2	
Global Emerging Markets Bond	1.1	-3.6	
Global Bonds	0.8	0.5	
£ Corporate Bond	0.6	-2.1	

IA SECTORS FALLERS

Sector	Last Month %	YTD%	52-Week Strength
North American Smaller Comp	-12.0	-5.5	
Japanese Smaller Comp	-10.7	-12.1	
North America	-9.3	-1.5	
Japan	-8.1	-11.3	
Global	-7.0	-5.9